FEDERAL TAX TREATMENT OF CAPITAL GAINS AND LOSSES

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

FIRST SESSION

NOVEMBER 2, 1983

Serial 98-53

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
30-182 O WASHINGTON : 1984

H781-36.

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FEDERAL TAX TREATMENT OF CAPITAL GAINS AND LOSSES

WEDNESDAY, NOVEMBER 2, 1983

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met at 9:40 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press releases announcing the hearing follow:]

[Press release of Wednesday, Oct. 12, 1983]

Hon. Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, Announces Hearings on the Issue of the Federal Tax Treatment of Capital Gains and Losses

The Honorable Dan Rostenkowski (D., Ill.), Chairman of the Committee on Ways and Means, today announced the Committee will hold a public hearing on the current treatment of capital gains and losses for Federal income tax purposes on Tuesday, November 1, 1983, at 9:30 a.m. in the Committee's main hearing room (1100 Longworth Building). The hearing will address proposals to (1) reduce the long-term capital gain holding period, (2) limit the deductibility of capital losses against ordinary income, (3) modify the tax treatment of options on securities and commodities futures contracts, and (4) provide alternative means of taxing capital gains, such as those in effect or under consideration in other countries.

In announcing this hearing, the Chairman stated that, "I recognize there is currently an interest in shortening the long-term capital gain holding period, including a recent proposal advanced by the Honorable Beryl Anthony, Jr., (D. Ark.) and supported by the securities industry to decrease the current holding period to six months and offset the revenue loss by coupling such a proposal with a decrease in the current $3,000 capital loss limitation to $1,000. I believe it is necessary to consider the broad range of issues surrounding the taxation of capital gains if we are to give proper focus to proposals dealing with the holding period. A comprehensive overview is particularly important in light of the need to coordinate any future legislature with recent changes in the capital gains treatment of commodities transactions and the growing interest in reviewing the appropriate treatment of options contracts."

BACKGROUND

Holding period.—Presently the holding period distinguishing between short-term and long-term capital gains is one year. It was increased from six months in the Tax Reform Act of 1976. For individuals, net long-term capital gains in excess of net short-term capital losses are reduced by 60 percent in determining taxable income. For corporations, the excess of net long-term gains over net short-term losses is subject to an alternative tax rate of 28 percent.

Capital losses.—Individuals may now deduct a limited amount of capital losses against ordinary income. The excess of net short-term capital losses over net long-term capital gains are deductible in full against $3,000 of ordinary income. (Prior to the Tax Reform Act of 1976 the limit was $1,000.) The excess of net long-term capital losses over net short-term capital gains must be reduced by 50 percent when deducted against ordinary income.

Options contracts.—Currently, regulated futures contracts (RFC's) are taxed on a mark-to-market basis annually and are subject to various rules to prevent tax straddle abuses. In addition, gains and losses on RFC's are treated as 60 percent long-term and 40 percent short-term, leading to a maximum tax rate of 32 percent on these transactions. Recently, the Committee has received a legislative proposal from certain representatives of the options industry suggesting that stock and commodity options be brought within the ambit of these same rules in order to provide parity between the treatment of options and the treatment of futures contracts.

Canadian system.—The recent Canadian budget includes a proposal to revise the treatment of Canadian common stocks owned by Canadian investors. Taxpayers could elect to put their Canadian stocks in an account which would be taxed on a mark-to-market basis. Stocks in the account would be given a basis adjustment for inflation, and losses on these stocks would be fully deductible against ordinary income.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard in writing no later than close of business, Wednesday, October 26, 1983, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This process will afford more time for members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, witnesses scheduled to appear before the Committee are required to submit 200 copies of their prepared statements to the full Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

Each statement to be presented to the Committee or any written statement submitted for the printed record must contain the following information: (1) The name, full address, and capacity in which the witness will appear as well as a telephone number where he or his designated representative may be reached; (2) A list of any clients or persons, or any organization for whom the witness appears; and (3) A topical outline or summary of comments and recommendations.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

Persons submitting a written statement in lieu of a personal appearance should submit at least six (6) copies of their statement by the close of business, Friday, November 11, 1983, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may submit additional copies for this purpose if provided to the full Committee office before the hearing begins.

[Press release of Tuesday, Oct. 18, 1983]

HON. DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A CHANGE IN THE SCHEDULE OF FULL COMMITTEE HEARING ON THE ISSUE OF THE FEDERAL TAX TREATMENT OF CAPITAL GAINS AND LOSSES

The Honorable Dan Rostenkowski (D., Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, today announced a change in the date for the public hearing previously scheduled to be held on November 1, 1983 (see Press Release No. 16), on the current treatment of capital gains and losses for Federal income tax purposes. The hearing will now be held on Wednesday, November 2, 1983, beginning at 9:30 a.m. All other hearing details remain the same.

Chairman Rostenkowski. The committee will come to order.

Good morning. We are here today to receive testimony on the Federal tax treatment of capital gains and losses. Specifically, witnesses are invited to address proposals to: one, reduce the holding period for long-term capital gains treatment from 1 year to 6 months; two, reduce the $3,000 limit on the deductibility of capital losses against ordinary income; and three, modify the tax treatment of options on securities and future contracts.

Witnesses may also discuss alternative systems of taxing capital gains. Finally, I understand that some, including our leadoff witness, will question whether preferential tax treatment should be permitted for so-called nonproductive assets; that is, jewelry, art, and other collectibles.

The proper method for taxing gains from capital assets has long been debated in tax policy circles. There clearly is sufficient reason for providing preferential treatment in taxing long-term capital gains. The potential for bunching income earned over a lengthy period of time into 1 year, the need to avoid taxing shear inflationary gains, and a concern for locking investors into present asset holdings to avoid high taxes on appreciation. The degree to which compensation is needed for either bunching or inflation effects on assets held less than 1 year should also be assessed.

I am well aware that there are those who feel that the time has come to reverse the changes made in the Tax Reform Act of 1976 by reducing the holding period to 6 months and reducing the limit on capital losses to $1,000. However, these proponents must carry the burden of proof in view of the fact that 60 percent of the gain from long-term investments is already excluded from tax.

In addition, the maximum tax rate on capital gains was reduced from 28 percent to 20 percent in the Economic Recovery Tax Act of 1981. I am also concerned with the income distribution effects of the changes that are proposed. While 72 percent of the benefit of reducing the holding period will be enjoyed by those with incomes over $50,000, 55 percent of the increased tax burden from a reduced limitation on capital losses will be experienced by individuals with incomes of under $50,000. Thus, the distributional effects of these changes present important policy issues.

Let me also observe that the committee solicits testimony today on the issues to be addressed legislatively in the areas of stock options and commodity future options. I am advised that the Senate Finance Committee, along with reducing the holding period and the capital loss limit to $1,000, agreed to changes in the rules governing options on stock and commodity future contracts.

Under these proposals, stock options would be subject to the straddle loss deferral rules, while options on future contracts would be brought under the mark to market system. We would like to receive comments on these proposals adopted by the Senate Finance Committee.

Our first witness is the Honorable Pete Stark, a distinguished member of this committee.

Mr. Anthony. Mr. Chairman, before Mr. Stark is recognized, I do have a prepared statement. With your permission, I would ask unanimous consent that I could introduce it in the record at this point.

Chairman ROSTENKOWSKI. There is no objection. Would the gentleman like to present the statement?

Mr. ANTHONY. The original holding period bill was a bill that I introduced earlier, which now has over 200 cosponsors, I would like the record to reflect my views on that bill. Rather than making the statements publicly, I will make them known as the witnesses are questioned. However, I would like to introduce my statement for the record.

Chairman ROSTENKOWSKI. Your entire statement will be included in the record.

[The prepared statement of Mr. Anthony follows:]

STATEMENT OF HON. BERYL ANTHONY, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARKANSAS

Mr. Chairman and members of the committee, I am extremely pleased to have the opportunity to discuss the subject of capital gains treatment, and in particular, the reduction of the 12 month holding period.

As I am sure the committee is aware, from 1942 to 1976 the holding period for long-term capital gain was 6 months. It was not until the passage of the "Tax Reform Act of 1976," that the holding period was extended to 1 year. Interestingly enough at one time or another, both Houses of Congress have, in fact, voted to reduce the holding period to 6 months. It was included in the House version of the Economic Recovery Act of 1981 and in the Senate version of TEFRA. Unfortunately, the proposal was deleted in the conference on both tax bills. I speak before you today to once again ask for your support in reducing the 12-month requirement.

On March 22, 1983, I introduced H.R. 2225, a measure designed to reduce the holding period for long-term capital gain or less from 1 year to 6 months. Since first introduced, the bill has picked up over 200 cosponsors, including Mr. Wright of Texas, Mr. Foley of Washington, Mr. Michel of Illinois, Mr. Lott of Mississippi, and 17 members of the Ways and Means Committee.

Mr. Chairman, we are convinced the reduction of the holding period will play an important role in promoting productive investment and will make the United States more competitive in the world economy. Considerable evidence has been brought forth indicating that the difference in tax-treatment between short-term and long-term transactions under present law prohibits an incentive for investors not to realize short-term gains.

Studies of capital asset sales data confirm that investors are "locked-in" to investments simply because they do not want to be taxed on short-term gains. This is a particular burden on the small investor. A wealthy investor faced with a paper loss can commit other funds to what he believes will be a good investment, while the limited investor with a small amount of money to invest will find himself locked in. This lock-in of investments has created inefficiency in capital markets, restricted the mobility of capital, and made it more difficult for small and new companies to obtain funds for growth and expansion.

In a recent study by the Opinion Research Corp., figures reflect that a reduction in the holding period to 6 months would increase individual investment more than any other change in tax policy, with an increase of $50 billion in the first year alone. The major beneficiaries of this increase in investment and expanded capital formation would almost certainly be smaller companies which have historically accounted for the major gains in employment.

Regardless of what has been said, a reduction in the holding period is not another tax break for the so called fat cats. Middle class taxpayers would receive a very large share of capital gains. For example, statistics of individual Income Tax Returns in 1979 indicated that 40 percent of realized net long term capital gain, less long term losses, was in the $50,000 and below AGI class. In addition, indirect shareholders, the workers whose pension funds are invested, will also benefit through increased market value.

Furthermore, a reduced holding period will not discourage long-term investment. Companies receive capital whether the stock is held by one shareholder or sold several times after the initial offering. However, they receive no funds when investors, wary of the opportunity to realize a gain, instead invest in high return investments that do not have a 1-year market risk.

Since first introducing H.R. 2225, I have heard a reoccurring argument regarding the revenue loss incurred if the bill became law. Revenue estimates of reducing the holding period from 1 year to 6 months vary from revenue gains of approximately $100 million to losses of about $200 million per year. Obviously, actual results would depend upon how much investors increase realizations of gains. In response to these arguments, I have introduced new legislation, H.R. 4231. This measure will marry the reduction in the holding period with a reduction of the capital loss limitation from $3,000 to $1,000. The legislative history of the holding period points to such a marriage. When TEFRA was passed in 1976, the extension of the holding period was phased-in simultaneously with an increase in the amount of excess capital losses which could offset ordinary income. In 1976 the holding period was 6 months and the loss offset limited to $1,000; in 1977 the holding period was 9 months and the loss offset $2,000; since 1978 the holding period has been 12 months and the loss offset limited to $3,000.

By combining these two provisions, we not only address any revenue losses attributed to a reduced holding period, but in fact we increase Federal revenues by $1 billion over the next 5 years. The Joint Committee on Taxation has estimated that the two changes would result in a minimum revenue gain of $226 million in fiscal year 1985, $249 million in fiscal year 1986, $232 million in fiscal year 1987, and $214 million in fiscal year 1988. The Department of Treasury figures reflect even higher revenue gains. I would like to add, that the provisions of H.R. 4231 passed the Senate on Monday of this week and will be included in the reconciliation package.

Mr. Chairman, our present economic situation demands sound tax policy in order to reduce the Federal deficit and stimulate capital investment. The passage of H.R. 4231 would accomplish both of these goals by increasing federal tax revenues, stimulating productive investment, improving capital mobility, and increasing personal financial holdings. I would hope the Ways and Means Committee will look favorably on this measure in the very near future.

Thank you.

Chairman ROSTENKOWSKI. Mr. Stark, you may proceed.

STATEMENT OF HON. FORTNEY H. (PETE) STARK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. STARK. Thank you, Mr. Chairman, for allowing me to start off your morning.

I ask unanimous consent that my prepared statement appear in the record in its entirety, and I will try to summarize it for you.

We are here to consider the change in the tax treatment of capital gains, and the Chair's opening statement, I think, pointed out some of the inequities. There is nobody in this room who has any interest in people in this country under $50,000 a year in income, because basically this legislation will not affect those people, and the unfairness of past tax policies in the past several years as proposed by the administration, I think, is well known to the public. We have given tremendous tax benefits to very large corporations and very wealthy Americans, and this would in fact compound the felony.

But I am here today to propose a way to offset a good bit of the Treasury loss that is proposed in this bill. I am a leading advocate of job-creating tax incentives, particularly where people can prove that the tax incentives are going to anything productive that will increase jobs in the United States.

There is some question as to whether trading in commodities futures or stocks and bonds on the exchange will do that, but to the extent there is a trickle down theory out there in the financial heavens, I would accept that that is an argument.

My proposal, however, is to remove the Persian rugs, the Ming vases, and the old wines, and the antique Chippendales, in short, the collectibles and the nonproductive assets from the favored capital gains treatment that they now receive.

Indeed, a case could be made for removing residences from capital gains treatment. The present code now allows you to trade a residence without tax consequences, and it allows you when you are over 55 to sell a residence and keep a certain, somewhat over $100,000 tax free. There is really not very much reason that we need to give residences the capital gains treatment in addition to those special treatments we already make.

In 1973, this would have saved some $10 billion had we removed it, and for somebody looking to raise revenue, it is an interesting area to explore.

My proposal in just dealing with collectibles would raise about $200 million a year and make the bill somewhat more revenue neutral. It would soften the blow to the Treasury, and be another step toward tax fairness.

You have indicated where the benefits of this bill will go, 73 percent of the benefits going to the richest Americans, but let me quote from some of today's witnesses' testimony.

You will hear later on from Mr. Mark Bloomfield of the American Council for Capital Formation, and his purpose is "to encourage the productive capital formation needed to sustain economic growth, reduce inflation, restore productivity gains, and create jobs for an expanding American work force," and I could not agree more.

What proud American, what bastion of free enterprise supporter could deny that Mr. Bloomfield is right? But I would like to submit now to the committee a piece of 12th century pottery that I found in northern Thailand when I was on an important trip for the Government, trying to track down narcotics dealers, and this piece of pottery is worth a small fortune, they tell me, and if I sold it, I suppose I would get capital gains treatment for it.

But can anybody tell me what this will do to sustain economic growth except perhaps my own, reduce inflation, restore productive gains, or create jobs? If anybody could show me how this piece of pottery will do that, I will vote for the bill.

But then, Mr. George Ball, from the Securities Industry Association is going to tell you that this bill will increase the ability of companies to raise capital and create new products and jobs. Some years ago, before the prints of the late 1800's were available, if somebody can see, and I know that some of you will want to look closer at this print, for its content matter would be of interest to many members of the committee, but it has gone up in value.

Now, if Mr. Ball can tell me how giving capital gains treatment—I paid $30 for this print, I think, back in 1965—how the profits that I have made on this print will go to increase the ability of companies to raise capital and create new products unless they print that same picture on their stock certificate, which might give some more interest to some of the securities, again, I would be glad to vote for the bill.

Mr. Lasch, of the American Electronics Association, will tell us that it will afford many small companies a badly needed opportunity to raise capital, and Mr. Ruhm of the Bessemer Securities Corp., is going to tell us that the lowered capital gains rate induces corporations to plow back profits into research and development, new plants and equipment, because there is less demand for dividends and more demand for increases in stock prices. How can a Persian rug do anything to help that?

And I think to a more serious matter, Margaret Sullivan of the Stockholders of America said that stockholders have to put their capital to work, and I could not agree more with any of the witnesses. We do need that. But there is no evidence, and I submit that there will be no evidence that could possibly be presented to the committee today that would indicate that collectibles, putting capital gains treatment on collectibles, precious metals, gems, and so forth will do anything to help our Treasury, our economy, or anybody but these very wealthiest of Americans who can afford to indulge themselves when taking income and investing it in collectibles.

Now, by contrast, I am submitting to you that we may raise $200 million or stem the tide of Treasury outflow by about $200 million if we exclude nonproductive assets from this bill. Yesterday I sat in my other Subcommittee on Public Assistance and fought with the administration to put $100 million to spend in AFDC, to spend $50 million for shelters for battered children and battered spouses. We were opposed every step of the way because we could not afford $5 million for education benefits for 19-year-olds who are poor. We were stopped every step of the way.

For those of you who might consider pay as you go budgeting, which may cure our deficit, here is the chance to put it to the test. If we want productivity, if we want jobs, have that understanding, that if we are going to give the capital gains tax treatment to Persian rugs and works of art and antiques, we are taking it out of the hides not only of low income America, but you are taking it out of poor children, you are taking it out of title 20 programs which help the elderly and the disabled. That is the tradeoff.

So, I would urge you, if we do anything to lower the capital gains withholding period, we stem the outflow of the funds from the Treasury and exclude the nonproductive assets. It is a good social vote. It is a good economic vote. And it makes sense for the Democratic Party to show Americans once again that we are the party of the people, and we will do the economic proper thing.

I thank the chairman and members for their indulgence, and I would be glad to answer any questions.

[The prepared statement follows:]

STATEMENT OF HON. FORTNEY H. (PETE) STARK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. Chairman, We are here today to consider changes in the tax treatment of capital gains and losses. Some of the plans being offered would lose hundreds of millions of dollars over the coming years. I do not believe we can do this given the budget mandate to Ways and Means and given our failure to meet our budget figures. If we give any money in this area, we should recover it by revenue gains in another area. I am here today to propose a way to offset any Treasury loss.

My proposal is to remove the persian rugs, the ming vases, the old wines, the antique chippendales—in short, the collectibles, from the favored capital gains treatment that they now receive. This would raise about $200 million per year, and make any bill more revenue neutral. This proposal would soften the blow to Treasury and be another step toward tax fairness for the majority of the American taxpayers.

Without this proposal, the benefit of the capital gains proposals before us would go mostly to the very wealthy, while those in the lower brackets would bear the burden. Taxpayers with income of $50,000 or more in income stand to gain 73 percent of the benefits if we shorten the holding period. The break for this group alone will cost Treasury $148 million. Lower income groups will end up paying the tab for this tax break. They will bear the brunt of paying 55 percent of the revenues gained by reducing the capital loss limitation.

Since most major collectibles are owned by those in the upper income brackets, removing the capital gains treatment from this group will restore equity to the changes being proposed. Today, we will hear testimony from others showing how important the capital gains treatment is to the growth of the economy. If you follow the rationale they give for their opinions, I'm confident you will agree with me—the reasons for giving capital gains treatment to stocks, and trade and business assets, simply don't fly when you apply those reasons to collectibles.

Let me offer some quotes from today's witnesses:

Mark Bloomfield of the American Council for Capital Formation: "[The ACCF's purpose is] to encourage the productive capital formation needed to sustain economic growth, reduce inflation, restore productivity gains, and create jobs for an expanding American work force."

George Ball of the Securities Industry Association: "Capital gains changes will increase the ability of companies to raise capital and create new products and jobs."

Arthur Lasch of American Electronics Association says: "Capital gains changes afforded many small companies a badly needed opportunity to raise new capital through offerings of common stock."

Thomas Ruhm of Bessemer Securities Corporation says: "The lower capital gains tax rate induces corporations to plow back profits into research and development and new plants and equipment because there is less demand for dividends and more demand for increases in stock price by shareholders.

"The beneficiaries of lower capital gains taxes are not only enterpreneurs, their employees and investors, but also the country at large, benefiting from increased technological development, healthy competition for large companies from small growing companies, excellent sources of jobs for our energetic young people, increased productivity and a renewed world-wide reputation for developing technology."

Margaret Sullivan of the Stockholders of America says: "Stockholders have put their capital to work."

Mr. Chairman, I won't read any more of these quotes. You get the picture. The only thing capital gains relief doesn't seem to do is cure rheumatism. But nowhere in all these statements is a justification for tax breaks for collectibles and other nonproductive assets. Indeed, the arguments all point to extending regular tax rates to them so that there is a larger incentive to move investments into productive assets.

I hope the committee will include my proposal in any change it makes in other areas of capital gains.

Chairman ROSTENKOWSKI. Thank you, Mr. Stark.

Do any of the Members have questions for our colleague, Mr. Stark?

Mr. GUARINI. Mr. Chairman, I commend you on your statement, my good colleague, but I think that part of the problem is, if I could add something, that some of these rug dealers, antique dealers, diamond dealers, art dealers, and pottery dealers do not pay any tax whatsoever, because from my understanding, this is the way some people launder money. This is the way you can take money from illegal activities and pass it through the antique markets, and they may not even pay capital gains taxes, much less any other kind of taxes.

I would like to see how we could get to the point that we can make some kind of record so that the Treasury would get what they are entitled to. The diamond market is famous for people passing through tremendous sums of money with no tax paid whatsoever. So it may be partly academic as to whether or not there is a capital gains tax or an ordinary tax, because from my observation there is no tax paid at all in some of these instances, and I am talking about transactions involving expensive artwork pieces, I am talking about paintings, I am talking about some of the past masters, I am talking about all kinds of emeralds, jewelry, gold coins. This is a cash money on the barrelhead market. I think that we should get to how we are going to get what we have coming to us, and how the people are not going to be cheated because of the cash transactions that take place in these marketplaces.

Mr. STARK. I thank the gentleman. As he knows, he has a great understanding of this, having the advantage of coming from New Jersey. He understands these transactions.

Mr. GUARINI. Do I get equal time on that? Oakland, Calif., is not a pristine location.

Mr. STARK. You are exactly right. It does allow for a great deal of illegal markets. The underground economy is funded with transactions in these kinds of currency, and I appreciate his comments.

Mr. ANTHONY. Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Anthony is recognized.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. Stark, I would just like to call your attention to a chart that is on page 7 of the joint committee's print. According to that particular chart, investors who are in an adjusted gross income class of $75,000 and below, are the people that you are trying to help, and would benefit as much as investors in the $75,000 and above.

So, it appears to me that the way the bill is constructed, again, not talking about your collectible issue, but just talking about reduction of the holding period alone, that there exists as fair a tax break as is possible in this complicated system.

You also mentioned that if we did not accept your proposal, that we would just be compounding the felony.

Mr. STARK. The gentleman is quite right. If you move down one bracket to $40,000, 70 percent of the American people under $40,000 get about 15 percent of the benefit from this bill. Your numbers are quite right. You could say it one way or the other, but I agree with the gentleman. I am referring to the same page that he is. Under $40,000, you get nothing out of this bill.

Mr. ANTHONY. I would just like to make my political statement now. You say that the administration is fighting, and we are having to scrap for dollars. Maybe we ought to focus attention on the Senate, which is costing our country about $250 million per day because they will not address the debt limit.

Mr. STARK. I concur with the gentleman.

Mr. DORGAN. Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Dorgan is recognized.

Mr. DORGAN. I want to commend Mr. Stark for his statement. I have tried to come to this hearing with an open mind, although the issue of capital gains tax has been with us for a long time and we have been debating the merits and demerits of it and the relative efficiency of it for many, many years.

One of the concerns I have, and I have expressed it before in this committee, is that we tend to think that there is behavior on the one hand and the tax code on the other, and changing one inexorably changes the other. In many cases we find that that happens, and I guess the question with the capital gains tax is: Are we developing a guidance system for investments that moves investment toward tax avoidance rather than productivity or moves investments toward tax avoidance rather than the market movement for investments. What is your analysis of that? That is my concern.

Mr. STARK. The perfect example is the bill that we will deal with in this committee on the offshore commodity funds, where we already gave the commodity traders a reduction from 50 to 32 percent and disallowed the capital gains because it was hard to tell when it was capital gains and when it was income. It was not enough that they dropped from 50 to 32 percent. They had to gimmick around to get these profits offshore so that they could get back down to 20, making their investors forgo ordinary loss treatment and the mutual funds are under water.

Not only was it a lousy investment. Everybody who invested in the darn thing has not gotten their money back yet. The whole thing was a tax avoidance scam, so it seems quite obvious that the gentleman's remark in this particular instance is quite right. It was a tax driven investment. It was a lousy investment. And when you start to get a whole industry growing in this country who is selling tax avoidance almost without concern as to the end product, we have, I think, created a monster.

Mr. DORGAN. Well, I think the important point to make is that all of us here share a common goal, and that is to develop an approach in which investment is maximized in this country to produce plants and create jobs and give us a strong economy. My concern is that our tax system has become so convoluted, such a punchboard of gimmicks, that we have developed, as many on this committee know, an $80 billion industry that creates nothing except a blizzard of paper in this country. The industry is staffed by mostly lawyers and accountants, and it saps our economic strength, it diverts our attention from the kind of productive things we ought to be doing with our investment to the nonproductive things that we do in the corner some place with green eyeshades trying to trade tax gimmicks or maximize the availability of this tax advantage or that tax advantage.

I just wanted to make the point that I think the testimony of Mr. Stark is excellent and is a good framework for beginning the discussion on the capital gains issue.

Mr. STARK. I thank my colleague.

Mr. MATSUI. Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Matsui is recognized.

Mr. MATSUI. Thank you, Mr. Chairman.

Mr. Stark, I want to commend you for some of the comments you made in your testimony as well. In your opinion, is there any real difference between some of the antiques that you showed in terms of their nonproductive aspects and the churning that goes on in the market so often?

Mr. STARK. Actually, in my opinion, trading shares of American Telephone or United States Steel——

Mr. MATSUI. Without additional capital investment.

Mr. STARK. That is right, without a new issue. The only case you can make, and it is an economic conundrum, is that by making the market itself more attractive, that there will be a higher price earnings ratio in the market, and therefore it will be easier to sell new capital. I think you can make a case if you study the Fortune 500 companies that any of them worth a darn have not sold much in the way of new equity anyway. It is almost all debt capital, and new capital is various forms of debt capital because of the interest deductibility, and so the incentive to dilute earnings is almost not there at all.

You can make the argument, but I do not have to buy it.

Mr. MATSUI. In the view of the fact that this chart in the Joint Taxation Committee's report has come up, I would like to make sure that there is an understanding of what this chart demonstrates. Those that make $50,000 and less will get 27.2 percent of the benefit if we reduce the capital gains period from 1 year to 6 months, but those that make $50,000 and above will get 72.8 percent.

In fact, those who get $200,000 and over will get 25 percent of the total benefit, and in order to put this in the proper perspective, I might just point out on page 14, if in fact we tried to make this revenue neutral, that is, by offsetting the loss of revenue from the capital gains reduction period, and increasing revenues to the Treasury because of the reduction of the income from $3,000 to $1,000 offset, you will find that 55 percent of that burden will be borne by those that make $50,000 and below, and only 45 percent of that burden will be borne by those who make $50,000 and above.

In fact, those that make $200,000 will only suffer 4.6 percent of that burden. So it is pretty obvious that there would be a shift if we make it revenue neutral, a shift of revenues away from those in the middle class to those that make $50,000 and above, and in particular those that make $200,000 and above. Is this correct from your analysis?

Mr. STARK. The gentleman is absolutely correct. It is a geometric growth of the unfairness that the Reagan tax proposals have forced upon the American public today, and this particular gentleman joins with you. I do not want to be any part of that.

Mr. MATSUI. I find it frankly incredible that we would consider such a proposal in view of the revenue loss that this Treasury has produced over the past 24 months, and second, in view of the shifts of the wealth of this country from the middle class to the upper income people, and I find that this is merely another step in that direction.

Mr. STARK. I appreciate the gentleman's remarks, and I concur wholeheartedly.

Chairman ROSTENKOWSKI. Mr. Frenzel is recognized.

Mr. FRENZEL. Mr. Chairman, I want to thank the gentleman for his testimony. I was not here, unfortunately. The Republicans were having a caucus. Is the gentleman suggesting that he opposes the proposal to reduce the holding period wholly?

Mr. STARK. I do oppose that. In a pragmatic sense I can get to 200 with my shoes and socks on. Seeing the train coming down the track, I am basically proposing that we exclude collectibles and nonproductive assets from the capital gains or indeed certainly from the reduced holding period, but I prefer to completely remove it, and then I could ease my conscience some in that we stem some of the reduction in revenues and we can at least pretend that we are directing all of the advantage toward productive assets which will create jobs and help America's economic growth.

Mr. FRENZEL. How do you define productive assets?

Mr. **Stark**. Well, the gentleman missed the dog and pony show, but I was quoting from other testimony, and I can show you a piece of ancient pottery and ask the gentleman how this could create jobs or produce much in the economy. It was paid for in the 12th century, and whomever's grave——

Mr. **Frenzel**. It was probably paid for many times thereafter. I guess my question is, if you and I exchange one share of stock, which is the most likely kind of transaction between us, is that productive?

Mr. **Stark**. I do not happen to think so, but as I replied to Mr. Matsui, you can make the argument, or the argument will be made that in raising the general level of prices in the capital markets and making them more attractive and broadening them, so to speak, you could make it easier for companies to sell into those markets.

I happen to think that is fallacious, but it is an argument that has no answer.

Mr. **Frenzel**. How about the argument that if you sell me that piece of pottery because I am old and doddering and I like pottery more than money, then you use my money to invest it in a new company. Is that a productive exchange?

Mr. **Stark**. Well, I do not mean to use this as a pejorative response to the gentleman, but that is what I referred to as trickle down investment analysis, and we are never quite sure that we could direct that. If in fact you want to say that where the transaction results in the sale of a collectible and it is invested in a new company, and we thought we could track that through, I would be willing to concur with the gentleman, but I do not know how we know whether you are really hooked on pottery and I could get you off of pottery as an investment habit.

Mr. **Frenzel**. Well, I think if I ever got any pottery, you could get me off of it.

Mr. Chairman, I have difficulty deciding when an investment is productive and when it is not, and I have a fear here that we are creating a distinction without a difference. Subject to the gentleman's need to discourse further, I yield the balance of my time.

Chairman **Rostenkowski**. Thank you, Mr. Stark.

The Chair calls our colleague, Mr. Zschau. Welcome to the committee, Mr. Zschau.

STATEMENT OF HON. ED ZSCHAU, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. **Zschau**. Thank you very much, Mr. Chairman. I appreciate the opportunity to appear before this distinguished committee to comment on the capital gains tax legislation and the proposal to shorten the holding period. I am going to focus my comments on the impact of such legislation on the high technology sector of our economy.

I have a prepared statement which I would like to have included in the record.

Chairman **Rostenkowski**. Without objection, your entire statement will be included in the record.

Mr. Zschau. Nearly 5½ years ago, on March 7, 1978, I had the opportunity to appear before this committee to describe the importance of risk capital investment to the continued growth and competitiveness of the electronics industry.

At that time, I was president of a small computer manufacturing company, System Industries, in Sunnyvale, Calif., and I was representing the American Electronics Association. In that testimony, I presented the results of a comprehensive survey of the electronics industry conducted by the AEA.

That survey indicated that it was the young companies in our industry, rather than the larger, more mature ones, that were creating most of the jobs. However, in order to do so, they needed constant injections of new risk capital. The survey confirmed that risk capital had virtually dried up, causing many electronics companies to stop growing, to go deeply in debt, or, like my own, to sell technology to the Japanese or the West Germans just to meet the payroll.

The most startling statistic from that survey, however, was that for every $100 invested in young electronics companies within a few short years, those companies were generating $30 per year in Federal tax revenues. In other words, the Federal Government could get a 30-percent annual return on somebody else's money if it would just encourage them to make such investments.

I suggested to the committee at that time that if the tax rate on capital gains were lowered substantially, more funds would become available to invest in young companies, and that the economic growth spawned by such investments would generate more Federal tax revenue even at the lower capital gains tax rate.

Under the sponsorship of the late Congressman Bill Steiger and members of this committee, Jim Jones, Bill Frenzel, and Ed Jenkins, a bill to reduce the capital gains tax rates was introduced on March 22, 1978, and by November 1978, the maximum rate on capital gains taxes had been cut from nearly 50 percent to 28 percent.

In my opinion, Mr. Chairman, the impact of this change in tax policy was enormous. By the end of 1979, just 18 months after the bill was introduced, $1 billion of new venture capital had been made available to professional venture capital firms for investment in young, high technology companies. Every year thereafter, more than $1 billion of new capital was added to the venture capital pool for such investments. In fact, last year, the amount of new capital was $1.8 billion. These amounts are in stark contrast to the average rate of $50 million a year that was made available for venture capital during the 1970's, when the capital gains rate was high.

The impact of the tax cut was felt in the public market as well. The number of public underwritings of small companies soared to more than 300 in 1981 compared to only 9 in 1974 and a low of 4 in 1975.

Let me recall the experience of my own company, System Industries, because I think it reflects the impact of this new investment climate. Back in 1978, when I testified, System Industries had sales of $19 million, employed about 250 people, but its growth was restricted by a lack of capital. At that time, we had only $200,000 in net worth, and we had an enormous debt of $4 million.

With the climate of risk capital investment dramatically improved, System Industries was able to make an initial public offering in 1980 and another in 1981. Today, with that infusion of new capital, System Industries has annual sales of more than $100 million. It employs 700 people, and it has a net worth of $30 million in contrast to the $200,000 back in 1978.

Now, there are some who suggest that System Industries' fortunes improved most when I left the company to run for Congress, but I maintain that the reduction of the capital gains tax and the resulting improvement in the environment for risk capital investment enabled my company and many others to expand more rapidly, to compete better in foreign markets, and to employ many more Americans.

Today I am often asked, is there enough risk capital today? I feel the answer is no. We need far more in order to make the breakthroughs necessary to maintain our technological leadership and to develop the products and operations that will make us competitive here at home and in foreign markets. We should continue to explore ways of enhancing the environment for risk taking, not just for investors, but for all kinds of risk takers, the entrepreneurs, the engineers, the innovators, the corporations that are developing new technologies.

Tax policy, particularly those related to taxation of savings and investment, should be reviewed regularly and improved with that fundamental in mind.

Now, regarding the holding period, I believe that reducing the holding period to 6 months would not have a significant direct impact on risk capital investments in young, high technology companies. However, it might have an indirect effect on such investments. I believe that shortening the holding period would increase somewhat the mobility of capital and thereby increase the attractiveness of equity investments in the public market.

With a more robust public market, the vehicle through which many venture capital investors ultimately realize their returns, the expected returns on venture capital investments might be increased. Such increases in expected returns would permit investors in technology companies to take greater risks or otherwise lower the cost of capital to such companies.

Mr. Chairman, let me conclude by stressing how important stimulating risk capital investment is to our high technology industries. Past reductions that this committee has made in capital gains tax rates have had an enormous impact, but we must continue to enhance incentives for risk capital investment.

Finally, Mr. Chairman, I notice from the witness list that you will be hearing later today from one of my constituents, Art Lasch, who is president of a young electronics company. I commend his testimony to this committee. I believe it should provide an update on the environment for risk capital investment, new company startups, and in particular technological innovations.

Mr. Chairman, I appreciate the opportunity to share my ideas with you and the committee, and I would be delighted to answer any questions that you might have.

[The prepared statement follows:]

STATEMENT OF ED ZSCHAU, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. Chairman, I appreciate the opportunity to appear before this distinguished Committee to comment on capital gains tax legislation and the proposal to shorten the holding period in particular. I will restrict my comments to the impact of such legislation on the high technology sector of our economy.

My Congressional District—a region in Northern California often called "Silicon Valley"—has had an outstanding record of advancing technology and creating new jobs. It has done so through an effective combination of entrepreneurship and advanced research and development. Currently, there are approximately 700 high technology firms in and around my district in fields ranging from microelectronics to genetic engineering.

Although the high technology sector has been a bright spot in our economy, it was not too long ago that its future appeared threatened.

Nearly 5½ years ago, on March 7, 1978, I had the opportunity to appear before this Committee to describe the importance of risk capital investment to the continued growth and competitiveness of the electronics industry. At that time, I was president of a small computer equipment manufacturing company, System Industries, in Sunnyvale, California, and was Chairman of the American Electronics Association Task Force on Capital Formation.

In that testimony, I presented the results of a comprehensive survey of the electronics industry. That survey indicated that it was the young companies in our industry, rather than the larger, more mature ones, that were creating most of the jobs. However, in order to do so they needed constant injections of new risk capital. They couldn't finance their growth through retained earnings or debt. Unfortunately, the survey confirmed what those of us in the industry had been feeling: Risk capital had virtually dried up. This scarcity of investment funds was causing companies like my own to stop growing, go deeply into debt, or, in many cases like that of System Industries, sell technology to foreign competitors in West Germany or Japan just to meet the payroll. Of course, our foreign competitors would then use that newly acquired technology to compete against us here at home.

Perhaps the most startling statistic of the survey was that for every $100 invested in a young electronics company, within a few short years that investment was generating $30 per year in federal tax revenues. In other words the federal government could get a 30 percent annual return on someone else's investment if it would just encourage people to make those investments! This $30 per year tax revenue figure was based solely on receipts from corporate income taxes and individual income taxes from the economic growth that the investment stimulated. It ignored any increases in capital gains tax revenues.

I recommended to the Committee then that the tax rate on capital gains should be lower substantially. I felt that if that were done, more funds would be available for starting new companies and creating new jobs. In addition, I felt that the economic growth spawned by such new investments would generate more—rather than less—tax revenues even at the lower capital gains tax rate.

Under the sponsorship of the late Congressman Bill Steiger and members of this Committee, Jim Jones, Bill Frenzel and Ed Jenkins, a bill to reduce capital gains tax rates was introduced on March 22, 1978. By November, 1978 the maximum tax rate on capital gains had been cut from nearly 50 percent to 28 percent.

The impact of this change in tax policy was enormous—particularly for young high technology companies. By the end of 1979, $1 billion of new venture capital had been made available to professional venture capital funds for investment in new and young companies. Every year since, more than $1 billion of new capital has been added to the venture capital pool for such investments. In fact, last year the amount of new venture capital made available was about $1.8 billion. These amounts are in stark contrast to the average of $50 million per year that was flowing into venture capital funds during the 1970's when the capital gains tax rate was high.

The impact of the tax cut was felt in the public market as well. The number of public underwritings of small companies (companies with a net worth of $5 million or less) surged to more than 300 in 1981 compared to only 9 in 1974 and a low of 4 in 1975. Even in 1978 there has been 21 such offerings.

The growth of my former company, System Industries, reflects the impact that this new investment climate had on so many young companies which were struggling at the time. In 1978, System Industries had sales of $19 million and employed about 250 people. However, its growth was stunted by lack of capital. It had at that time only $200,000 of net worth and an oppressive $4 million of debt.

With the climate for risk capital investment dramatically improved, System Industries was able to make an initial public offering of stock in 1980 and another in 1981. Today, with that infusion of capital financing its growth, System Industries has annual sales of more than $100 million, employs 700 people, and has a net worth of more than $30 million which provides a solid basis for further growth and new job creation.

Although there are some who suggest that System Industries' fortunes improved most when I left the company to run for Congress, I maintain that the reduction of the capital gains tax and the resulting improvement for risk capital investment enabled the company to expand more rapidly, compete better in foreign markets, and employ many more Americans. I would emphasize further that System Industries is but one example—certainly far from the most dramatic example—of the relationship between our tax policy, capital formation, and job creation in the high technology sector.

I am often asked: Is there enough risk capital today? The answer is no. Although from time to time it may seem that there is enough capital to finance all the new ideas that we have, I can assure this Committee that we need far more in order to make the breakthroughs necessary to maintain our technological leadership and to develop the products and the operations that will make us competitive here at home and in foreign markets. Also, when more capital is available, more people will be encouraged to come forward and take the risks attendant with trying new ideas and starting new companies which create new jobs.

We should continue to explore ways of enhancing the environment for risk taking, not only for investors, but also for entrepreneurs, innovators, and corporations. Tax policy, particularly our policies related to taxing income from savings and investment, should be reviewed and improved with that fundamental in mind.

Toay, this Committee is exploring the advisability of shortening the holding period required for an investment to qualify for long-term capital gains tax treatment. Although in my opinion such a change would not have a significant direct impact on risk capital investments in young high technology companies, shortening the holding period might have an indirect effect on such investments that should not be ignored. Shortening the holding period would incease somewhat the mobility of capital and, thereby, increase the attractiveness of equity investments in the public market. With a more robust public market—the vehicle through which many venture capital investors ultimately realize their returns—the expected returns on venture capital investments might be increased. Such increases of the expected returns would permit investors in small private companies to take higher risks or lower the cost of capital to such companies.

Mr. Chairman, let me conclude by stressing how important stimulating risk capital investment is to our high technology industries, our industrial competitiveness, and the creation of new jobs. Past reductions in the capital gains tax rates have had an enormous impact. We must continue to forge ahead to further enhance incentives for risk capital investment. Although the shortening of the holding period would only have an indirect impact on the environment for risk capital investment, I believe its effect would be positive.

Thank you for your kind attention. I would be delighted to answer any questions you might have.

Chairman ROSTENKOWSKI. Are there any questions? Mr. Guarini is recognized.

Mr. GUARINI. You made a very good case for risk capital. How do you feel about the trading of stocks of our old smokestack industries as compared to the new ventures of the technological new companies?

Mr. ZSCHAU. I think that one of the reasons why we refer to those basic industries as old, sometimes tired, smokestack industries is because of the lack of investment that those companies have made in new processes and in equipment that would enable them to maintain their competitiveness in world markets. We should not ignore those industries. We should be finding ways to stimulate new investment in those industries, because that is the only way that they are going to maintain their competitiveness.

Risk capital investment is needed not just for what people call the sunshine industries or the sunrise industries. It's needed for all kinds of industries where growth opportunities exist. Contrary to some thinking, I believe that there is a lot of opportunity left in world markets in steel and automobiles and durable goods. I would hate to see our tax policy do anything other than encourage investments in those industries.

Mr. GUARINI. Now, does your thinking divide when it comes to antiques and persian rugs and jewelry such as diamonds and other commodities of that sort?

Mr. ZSCHAU. I go along with the same line of thinking that my colleague, Bill Frenzel, was suggesting. It is very difficult to distinguish between assets. When I sell an asset that you may call nonproductive, that capital that I get may later be invested in something that you would call productive. Therefore, I think it is dangerous to compartmentalize and to arbitrarily write tax policy to call some assets productive and other assets not.

Mr. GUARINI. Now, would reducing the holding period from 1 year to 6 months create any instability in the marketplace as to investments moving too fast, a quick profit without the capital formation being a solid investment?

Mr. ZSCHAU. I do not consider myself an expert in the public markets, and I would defer to people who are, but my hunch would be that it would not create an instability.

Mr. GUARINI. Thank you very much.

Chairman ROSTENKOWSKI. The committee will stand in recess until 10:25.

[Whereupon, a brief recess was taken.]

Mr. PICKLE [presiding]. The committee will come to order.

Our colleague, Congressman Jim Jones, was scheduled to testify earlier, but was not able to be here. He has now returned, so, Mr. Jones, if you would take your position at the table, we would be pleased to receive your testimony.

STATEMENT OF HON. JAMES R. JONES, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

Mr. JONES. Mr. Chairman and members of the committee, I will be brief, and I would ask that my full statement be included in the record.

Mr. PICKLE. Without objection.

Mr. JONES. I do apologize for not being here earlier. Essentially, what my testimony says is that while we have to focus on the capital gains tax matters, we should not lose sight of our overall macroeconomic position and how the huge deficits affect capital markets.

One thing is very clear, even if we cannot predict when the clash of public and private borrowing is going to hurt economic recovery, that these large deficits are soaking up what formerly went into capital formation and capital investment. This will have a debilitating effect on the long-term growth of this economy. It will syphon money away from capital investments. Eventually, this will make us less competitive and less productive in the future.

Let me comment on a bit of history of the 1978 capital gains reduction. One of the things that is very clear from the 1978 tax act, in which the capital gains upper rates were dropped from 49 to 28 percent, is that contrary to the claims of those who oppose that reduction in capital gains taxes—who said that this would be a great loss of revenue to the Treasury—just the opposite has occurred. Not only has there been greater receipts from the capital gains tax, but there has been a substantially greater flow of capital into new companies, new issues.

One last comment, Mr. Chairman. In my testimony I endorse the proposal by our colleague, Mr. Anthony from Arkansas. As a cosponsor of that bill, I believe that this will be a very important further step in trying to generate capital and to keep our capital markets thriving and growing.

The full testimony can be read, and I will not take more time of the committee. I do appreciate this opportunity to appear before the committee.

Mr. PICKLE. Thank you, Mr. Jones. A few minutes earlier, our colleague, Mr. Zschau of California, testified much along the same lines as you have; namely, that the reduction in the maximum capital gains tax rate from 49 to 28 percent proved very helpful to the high tech industry, particularly the young companies, and that he was very much in favor of reducing the 6-month period, even though it would have only an indirect benefit on young, high tech companies. So, I think your testimony supports his statement, and we are glad to have it.

Any questions, Mr. Stark?

Mr. STARK. Yes. I thank my colleague for his testimony, and I missed the chance to ask Mr. Zschau, but I would ask Jim the same thing. There has been testimony previously from witnesses saying they could not tell the difference between a productive and nonproductive asset, which I think is a naive assumption. I think many of us can tell the difference in productivity between a lathe and a persian rug, for example.

But then the argument would follow, well, if you sell the persian rug and pay a little less tax, you will have money to invest. Does that argument not lead you eventually to say that any reduction in tax will improve the investment climate in this country, and would we not be more fair, we could lose the same amount of revenue by dropping the maximum rate, say, from 50 to 49, would we not be more fair, rather than just fiddling around with the capital gains tax more just to say, all right, let us drop the tax rate a half a point and keep the code a little simpler?

Mr. JONES. I think we are going to go toward a broader reform of the total tax code, to simplify it considerably and to take some of the distortions out of the tax code. I personally favor some form of progressive income tax with very few exemptions and deductions. I do think that approach is fair, and it lets capital go to the places where it belongs.

I also believe regulations can be written that delineate between productive and nonproductive assets, if we determine it is good public policy to have a tax code that encourages investment in productive assets. I think, for the most part, the 1978 capital gains reductions caused capital to flow into highly productive investments in the field of new growth companies and high tech companies. The capital infusion in these new issues has been very remarkable.

So, I generally agree with you. But I guess the thrust of my statement today is to endorse the Anthony package on the 6-month holding period. I think that the broader reform on what is a productive asset should wait for a broader tax reform package, hopefully in 1985. I hope it will be an imaginative reform package.

The other point that I made in my written testimony deals with the question of indexing. If there is ever a part of the tax code that merits indexing, I think the capital gains tax rate or basis would be it.

However, I come from a proposition against indexing as a matter of public policy. We talk about the uncontrollable parts of the budget. Previously the uncontrollable part was the spending side. Now it will be on the revenue side as well. It seems to me that we ought to make budget decisions on the basis of economic realities of the time, rather than expanding the uncontrollabilities in the budget. I come out against expansion of indexing into the capital gains area.

[The prepared statement follows:]

STATEMENT OF HON. JAMES R. JONES, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

I would like to thank you for providing me this opportunity to submit testimony on the federal tax treatment of capital gains and losses as well as its ramification on capital formation in America.

The level and method of taxation on capital assets is vital to capital formation. Past decisions to reduce the rate of taxation on this form of income have improved productivity, enhanced the mobility of capital, and increased net domestic savings. Nonetheless, much remains to be done to improve the efficiency of capital markets. Several proposals I plan to discuss today will strengthen the climate for savings and investment. These proposals should be enacted this year.

OUTLOOK FOR CAPITAL FORMATION

Further reductions in and changes of the taxation on capital assets are only part of the solution our capital markets tell us to address. Even abolition of all capital income taxes begs the question, and falls short of the answer. Future prosperity and the outlook for capital formation are dependent upon getting our fiscal house in order.

Two years have passed since President Reagan's economic program took effect. In the two budget cycles since 1981, congressional tax writers have been confronted with an economy mired in a deep recession, the highest unemployment rate in postwar history, and budget deficits soaring to unprecedented levels. Despite our progress in narrowing the gap between revenue and spending, and the help received from a revival in our short-term economic health, we have been unable to reduce federal deficits to manageable levels.

America faces a budgetary crisis. Grim forecasts of budget shortfalls in the range of $200 billion persist—at least for "as far as the eye can see." We have political catatonia. Both parties are unwilling to be the first in not only prescribing, but in swallowing, tough economic medicine. It is unlikely we will resolve our economic quagmire before the 1984 elections.

I repeat: we face a budgetary crisis. This means we also face a capital formation crisis. If nothing is done about the existing structural deficits, at some point in the recovery private borrowing and unprecedented public borrowing will collide—given the Federal Reserve's anti-inflationary stance. Interest rates will rise. Some foreign capital will flow into this country to fill the gap between domestic saving and the cumulative public and private borrowing demands. As a result, however, our dollar will remain overvalued. Our exports will fall. Vital sections of the economy will wither. Capital formation and productivity growth will be, once again, non-existent.

Budget deficits do matter. In fact, they matter a great deal. It doesn't take more than a fundamental understanding of national income accounting relationships to comprehend that investment is limited by savings and, eventually, deficits will crowd out private investment in a high employment economy. Budget deficits do matter, and they matter a great deal in any discussion on the outlook for capital formation in the 1980's.

The events of the past few weeks—the fact that we have even been unable to pass an increase on the national debt ceiling—reflect that there is no consensus on what, if any, action is needed. Eventually, the Administration and Congress will have to face the fact that taxes must be raised to pay for the cost of government. When the time comes to get serious about restoring fiscal and monetary sanity, we should be mindful of which tax policies are imperative to ensure vigorous and consistent economic growth. We should not blindly follow veiled promises and unproved theories. We should rely on past experiences in tax policy. Our decisions should not be made in a vacuum. For this reason, it is particularly relevant that we review the impact of the 1978 reduction in capital gains taxes.

IMPACT OF 1978 REDUCTION IN CAPITAL GAINS TAXATION

Congress has enacted many tax measures designed to improve the rate of saving and investment. Of these many measures, one has a documented success record. The Revenue Act of 1978 reduced the maximum capital gains tax rate for individuals from about 49 percent to 28 percent.

Congress took this action because we believed that the high tax rate on capital assets had resulted in a shortage of funds for our capital markets. The evidence was overwhelming. Shareholders of public corporations (as a percentage of the United States population) has steadily declined from a high in 1969 of 15½ percent to a level of 8½ percent in 1979. Available funds for venture capital companies and partnerships declined from $171 million in 1969 to $10 million in 1975. Public equity capital raised by companies (having a net worth under $5 million) was $1.367 billion in 1969 in 698 offerings. In 1975, only $16 million was available through four offerings. It was evident Congress needed to take action to reverse the flight of capital from productive investments.

The 1978 legislation brought about impressive results. Investors began returning to the capital markets and the flow of funds dramatically increased. An overall improvement in the investment climate has come about since passage of the Act. Let me briefly summarize some of the evidence.

New capital, raised through initial public stock offerings of corporations critical to business growth and employment, hit a low in 1977 when only $153 million was raised. From 1978 to today, the number of companies going public has soared as well as the amount of money raised in doing so. In 1978, new capital from initial public stock offerings was $249 million. That amount doubled when the amount of money raised in 1979 jumped to $506 million. In 1982, $1,445 million was raised through initial public stock offerings.

Since passage of the 1978 Act, stock market indices have also improved, especially the indices where small growth companies are listed. Between 1979 and June 1982, the AMEX and NASDAQ indices have risen 222 and 170 percent, respectively.

Funds raised by venture capital firms, often known as the seed money for economic growth, hit all-time lows between 1970 and 1977. Between 1978 and 1982, the industry raised an astonishing $4,789 million. This six year figure is even more impressive when compared to the total capital raised in the seven years between 1970 and 1977. During these seven years, venture captial firms raised a total of $466 million.

The combined total of venture capital firm disbursements and new capital from initial public stock offerings provides a valuable yardstick on the amount of funds for our growth companies. Between 1975 and 1978, this total was $2,401 million; from 1979 through 1982, the total climbed to $11,363 million.

The action taken in 1978 was both effective and efficient. The turnaround in our country's investment climate (reflected in the statistics documented above), has brought about an environment where capital formation is encouraged and bolstered. Nevertheless, many critics of the 1978 Act remain skeptical of the evidence. Although the number of critics is dwindling, let me take a moment to address their charges.

First, it should be emphasized that the action taken in 1978 was in response to a deterioration in the amount of capital individuals were committing to risk-taking. We wanted to improve and increase the flow of capital into our financial markets. The revenue effects of the measure were not a central focus during the debate, given the historical level of total capital gains taxes paid.

However, critics charged the 1978 Act would erode government revenue, do nothing for the state of capital formation, and would bring a windfall for rich investors. Have these charges held up during the time that has passed since our action?

Unlocking of capital assets which increased realizations since 1987 has not been a temporary phenomenon. Accordingly, total revenue paid from captial gains income has continued to increase. Preliminary data from the Department of Treasury Reveals that total capital gains taxes paid in calendar year 1987 was $9.3 billion. The amount paid on capital income increase to $12.5 billion in calendar year 1980.

The amount of capital gains realizations between 1975 and 1981 also shows great improvement. The following chart based on information from the Department of Treasury's publication entitled, Statistics of Income demonstrates that capital realizations continue to rise:

CAPITAL GAINS AND LOSSES ON RETURNS WITH TAX LIABILITY

Year	Net capital gain in adjusted gross income	Net capital loss deducted in computing adjusted gross income	Excess of net capital gain over net capital loss
1975	14.0	1.6	12.5
1976	18.4	1.5	16.9
1977	23.4	2.6	20.8
1978	24.4	2.7	21.7
1979	29.1	2.6	26.5
1980	30.5	2.7	27.7

Did the action taken in 1978 result in large windfall gains for the rich investors? No. In fact, the Department of Treasury's Statistics of Income shows that the amount of net capital gain included in adjusted gross incomes of $100,000 (or more) climbed from $6.8 billion in 1978 to $11.7 billion in 1979. More important, however, is the fact that from 1975 to 1980 an infusion of young, medium income investors became shareholders in our capital markets. For example, a recent survey by the New York Stock Exchange shows that the median age of all shareholders in the United States in 1975 was 52.6 years. In 1980, the median age of all shareholders dropped to 45.5 years. Moreover, in 1975, 32 percent of all shareholders in the United States had an average portfolio size of under $5,000.

The capital gains cut in 1978 worked. Documents that are available reveal that we were successful in creating a new climate for investment. It would be helpful, however, if the study which Congress instructed the Department of Treasury to compile were available to us today.

FURTHER CHANGES IN CAPITAL GAINS TAXATION

As a cosponsor of H.R. 4231, legislation reducing the capital gains holding period from one year to six months, I want to join the many others testifying today in urging its adoption. I want to commend my colleague, Beryl Anthony, for his fine effort in keeping this matter before the House of Representatives. Studies show that adoption of this measure would increase individual investment by as much as $50 billion in the first year. Not only would we increase the amount of capital available, but we would foster greater efficiency in our capital markets.

Another option before the Ways and Means Committee is the proposal which would index for inflation the base of certain capital assets. H.R. 3651, introduced by my friend, Bill Archer, would apply to most corporate stock and real property. In my judgment, the best case that can be made for indexing, is the case that is made for indexation of capital assets. The evidence proponents of this proposal have presented is convincing. Nevertheless, I am fundamentally opposed to the concept of indexing. We should not accommodate inflation, we should beat it. I am not ready to give up the fight on inflation. Furthermore, current indexing is the single largest component of Federal spending over which the Congress and Capital markets perceives us as having little control. We should not create more "uncontrollables," we should limit the demands on our fiscal capacity.

The maximum capital gains tax rate for the corporate investor should not be higher than that levied on individual investors. When we lowered the individual capital gains rate in 1981, from 28 to 20 percent, we failed to reduce the corporate capital gains rate. This disparity has resulted in capital inefficiency as the form of doing business affects the rate of taxation. The corporate investor should be on a level playing field with the individual investor.

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CONCLUSION

It is difficult to recall another period in recent history when our fiscal house was as untidy as it is today. Congress is stalemated over the increase in the debt ceiling. We are blaming the messenger for the message. We order a meal, but refuse to pay the check.

Business-as-usual budgeting cannot persist. Our economy cannot sustain $200 billion deficits for the indefinite future. Private borrowing and the insatiable public thirst for debt will eventually collide. We face a capital formation crisis.

After the 1984 elections a search will begin for tax policies that will produce vigorous and stable growth, and will seek to close the gap between receipts and spending. We should learn from our past. We should be mindful, as well, what the original supply-side mania was all about.

Mr. STARK. I thank the gentleman.

Mr. PICKLE. Are there other questions by members of the committee?

Mr. DUNCAN. I have no questions. Thank you, Mr. Chairman.

Mr. PICKLE. We thank you, Mr. Jones. We appreciate your testimony. Now the Chair will ask Secretary Chapoton if he will take his position. We are always glad to have you here, Mr. Chapoton. We look forward to your testimony.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Thank you, Mr. Chairman.

I am pleased to be here to present the administration's views on the holding period for long-term capital gain treatment, and I want to mention several issues concerning the taxation of options and straddle transactions.

Dealing first with the capital gains and losses, as you know, presently capital gain income does enjoy a preferential rate, 28 percent for corporate capital gains and a maximum 20-percent rate for individual capital gains. There is a limitation on the deduction of losses on capital assets. In the case of corporations, deductions of losses are allowed only to the extent of capital gains, and for individuals to the extent of capital gains plus $3,000 of ordinary income.

The proposal before you would decrease the long term capital gain holding period from 1 year to 6 months, and would offset the small revenue loss resulting from that change by coupling the proposal with a decrease in the limit on the deductibility of capital losses against ordinary income from $3,000 to $1,000 a year.

The administration supports restoring the 6-month holding period the administration supports that was in effect prior to the 1976 Reform Act. That is, going back to the 6-month holding period. That reduction would increase after-tax returns on savings by making gains on assets held between 6 and 12 months long term. This increase in the return to savings would be partially offset by a reduction in the tax deduction available to individuals for losses on assets held during that period, because those losses would be changed from short-term to long-term capital losses.

We think on balance that there would be a net reduction in capital gains taxes absent any behavioral change from shortening the holding period. The incentive to save and to hold corporate stock would be improved, and in addition the holding period change would cause a net reduction in artificial barriers which now exist that impede transactions and thus improve to some extent the efficiency of capital markets.

The provision that is coupled with this under the proposal before you is the reduction of the limit on capital losses from $3,000 to $1,000. We do not support that reduction. Some limitation on the deductibility of capital losses is necessary to prevent taxpayers who have both accrued gains and losses on different assets from claiming large deductions by recognizing their losses even though they are deferring unrecognized gains on the assets which have appreciated.

On the other hand, any limitation on losses can be inequitable because it prevents taxpayers who have actually suffered losses on their entire portfolio from recognizing all of their losses in the current year. So, for that class of taxpayers, any limitation on the loss side overstates their taxable income, their economic income, and is too harsh.

The choice of a loss limitation thus involves balancing the need to restrict the opportunity to claim large losses when no net economic loss exists and the need to allow deductions to taxpayers who have net losses on their entire portfolio. The exact loss limitation which would meet those competing considerations is basically unknown and unknowable, but we would simply point out that the $3,000 loss limitation should not be reduced simply because the holding period is reduced to 6 months. There is not a direct relationship between the two, and thus we cannot support a reduction in the $3,000 loss limit.

Mr. Chairman, I would like to turn now to the options and straddles transactions. I will go through these rather quickly. Since the enactment of the straddle rules in 1981 as a part of ERTA, there have been two developments which raise some important tax issues in the area of options and straddles.

First, it has become apparent that straddle transactions in exchange traded stock options are being widely used in abusive tax sheltering transactions, and second, trading in several new option products has commenced. These include the so-called commodity options, options on regulated future contracts, cash settlement options, options on stock indices that are settled in cash, not in property, and physical options, options on debt instruments and foreign currencies.

We think legislation is needed to eliminate the opportunity to engage in tax shelter transactions through straddles in exchange traded stock options, and to rationalize the tax treatment of the new option products with the rules that were adopted in 1981, and the general tax rules for options.

Prior to ERTA, the code did not contain any specific rules dealing with straddle transactions. ERTA adopted two basic provisions. One is the provision in section 1256 relating to regulated future contracts, and the other is section 1092, the loss deferral rules.

Basically, the first provision relating to regulated future contracts provides what we are all now familiar with, the mark-to-market rule, so that all commodity futures traded on a regulated futures market are marked to market at the end of the year as if the transaction was closed out at the fair market value on the last business day of the year, and any net gain or loss is taxed as though 60 percent of the gain were long-term capital gain and 40 percent were short-term capital gain. This so-called 60-40 treatment results in a maximum tax rate on RFC contracts—regulated future contracts—of 32 percent.

The loss deferral rule, the section 1092 rule, governs the taxation of straddles that are not composed exclusively of RFC's and under these rules basically the deduction of a loss leg in a straddle transaction is deferred when it exceeds the unrealized gain on the offsetting position. The loss is deferred and carried forward and allowed in subsequent years, but is also subject to the loss deferral rule in the subsequent years.

The tax rules applicable to commodity options and to cash settlement options are not clear, and the tax straddle rules are specifically inapplicable to stock options.

The Chicago Board of Options Exchange [CBOE] has made a proposal to deal comprehensively with the problems presented by tax straddling in stock options, and the uncertainty concerning the commodity and cash settlement options. Basically their proposal would remove the exemption from the tax straddle rules for stock options and for stock where it is part of a straddle, and it would make the cash settlement option and commodity option rules symmetrical bu providing rules that parallel those applicable to stock options, and then, most importantly, exchange traded options, that is, all stock options, physical options, cash settlement options, and commodity options, would be subject to mark to market, and would have the 60-40 rule apply, so there would be a maximum 32-percent tax rate.

The CBOE proposal represents a thoughtful and responsible analysis of the problems in this area that face both the Government and the industry. We agree with parts of the proposal, but we are unable to support it in its entirety. I will just tick off our position on the principal areas.

First, with regard to stock and stock options, we think that the present exemption from the straddle rules for exchange traded stock options should be removed. We have seen substantial indications that taxpayers are attempting to defer taxation of income through tax straddles in exchange traded stock options, and we urge the committee to take action to make these transactions subject to the straddle rules.

We have discussed this with the CBOE and other representatives of the stock exchanges and the option exchanges. We do think that a case can be made for not applying the straddle rules in the case of covered calls if it can be shown that those covered calls are not tax motivated. The suggestion is that the straddle rules not apply to covered calls unless the covered call is written deep in the money. That is, the strike price is far below the current price of the stock the day the option is written.

We think there should be some exception, and we want to work with the committee and the industry to see where that exception should be.

Turning to commodity options, we simply think that legislation is essential to end the opportunities that currently exist for taxpayers to obtain a reduced rate of tax through selective exercise of commodity options resulting in a whipsaw of the Government by claiming inconsistent tax treatment. Our proposal is that legislation be enacted treating options on commodities in the same manner as the regulated future contracts. That is, they would be marked to the market and would receive 60-40 treatment.

We think this is consistent with the general statutory scheme for the taxation of options already in the code. That is, you tax the option in the same manner as a transaction in the property underlying the option.

With respect to cash settlement index options, we support legislation to amend section 1234 to simply make it clear that the fact that the option is settled in cash and not property does not mean it is not subject to the option rules, so it would be subject to the present option rules in the code.

Under the proposal of the CBOE, as I mentioned, exchange traded options would be taxed under the mark to market and the 60-40 rules applicable to commodity future transactions. We must oppose extending these rules to all exchange traded options. We would point out the RFC treatment involves two distinct rules. One is the mark to market, and the other is the 60-40 treatment.

In the case of mark to market, we are concerned that if you apply or attempt to apply mark to market to all option transactions—a rule that would provide a simplification that would result from mark to market as opposed to having to apply the straddle rules to the option area—that you have mixed straddles. That is, part of the straddle is on an exchange, and therefore subject to mark to market, and part of the straddle is not on the exchange, and therefore the mark to market rules do not solve your administrative problem. This is not a significant problem in the commodity futures market. There is not nearly the degree of mixed straddles that we think would result in the stock options context.

We also have to express concern about the 60-40 tax rate; that is, the maximum 32-percent tax rate. We do not see a policy justification for treating 60 percent of the gain on such transactions as long term without regard to the holding period of the option. And we think that a special rate of tax for a limited category of investments does raise a very fundamental tax policy question. We recognize, however, there is a competitive problem here. That is, that we have 60-40 treatment for commodity futures contracts and we are supporting 60-40 treatment for options on commodity futures. There is competition between these options and other option contracts, and it can well place the other option markets at a competitive disadvantage, but we are not satisfied that the solution to that problem is to move all options to 60-40 treatment. If you follow this line of reasoning, you will pretty soon be at 60-40 treatment for basically all capital transactions, and obviously a basic restructuring of the taxation of capital transactions would be involved. We are simply not ready to go that far at this time.

And finally, we do suggest that the committee should consider extending mark to market to options market makers. We think that there is the possibility of significant tax deferral and abuse in the option market maker context, because, for the most part, they will not be subject to the straddle rules, even if we adopt and apply 1092 to stock options, both because it is hard to identify the offsetting positions, and because they would be exempted with respect to transactions entered into for the primary purpose of maintaining a hedged position.

So, we think you ought to seriously consider going to mark to market for options market makers, but we could not support extension of 60-40 treatment to this class of taxpayers. They are basically dealing in property that is close to inventory, and thus we see no policy justification for providing a reduced rate of tax on those transactions.

Mr. Chairman, that summarizes very briefly a complicated subject in the straddle world. Our statement is quite long, and I know it will be entered as a part of the record, so I will just conclude there.

[The prepared statement follows:]

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. Chairman and members of the committee, I am pleased to have the opportunity to present the views of the Treasury Department concerning the holding period of long-term capital gain and loss treatment, the limitation on deductability of capital losses against ordinary income, and various issues concerning the taxation of option and straddle transactions.

The Treasury Department supports the reduction of the long-term capital gains holding period to six months. We cannot support, however, a reduction on the limitation of the deductability of capital losses against ordinary income.

In the area of options and tax straddles, we urge the Congress to eliminate the exemption from the tax straddle rules for exchange-traded stock options, and to clarify the tax treatment of options on commodity futures contracts and cash settlement index options. We oppose an industry proposal to extend partial long-term capital gain or loss treatment and the mark-to-market system of taxation to all exchange-traded options, although we believe that such treatment is appropriate to options on commodity futures contracts. We also think that there may be merit in the proposal not to extend the straddle rules to certain covered call writing transactions.

CAPITAL GAINS AND LOSSES

PRESENT LAW

Under present law, capital gain income is subject to favorable tax treatment relative to ordinary income. Corporations pay a maximum tax of 28 percent on net capital gains, compared to 46 percent on ordinary income. Individuals are taxed on only 40 percent of net capital gains. As a result, the maximum rate of tax on net capital gains for individuals is 20 percent, while the maximum rate of tax on ordinary income is 50 percent. Net capital gain subject to this special treatment is the long-term capital gain recognized during the taxable year net of any long-term capital loss, reduced by the excess, if any, of short-term capital losses over short-term capital gains. The holding period for distinguishing between short-term and long-term capital gains and losses is one year.

Current law limits the deductability of capital losses. Corporations are only permitted to deduct such losses to the extent of any capital gains. Individuals are permitted to deduct capital losses against capital gains and up to $3,000 of ordinary income each year. Long-term losses are reduced by half when deducted against ordinary income. Thus, $6,000 of long-term losses can offset $3,000 of ordinary income each year. Corporations are permitted limited carrybacks and carryforwards of unused capital losses. Individuals can carry unused capital losses forward indefinitely.

PROPOSAL

A proposal has been advanced to decrease the current long-term capital gain holding period to six months and to offset the revenue loss by coupling such a proposal with a decrease in the limit of the deductability of capital losses against ordinary income from $3,000 to $1,000.

DISCUSSION

Holding period

Prior to 1976, the long-term holding period was six months. The Tax Reform Act of 1976 increased the holding period to nine months in 1977 and one year in 1978 and later years.

The Administration supports restoring the six-month holding period that was in effect prior to the Tax Reform Act of 1976. A reduction in the holding period would increase after-tax returns on savings of individuals by making gains on assets held between six months and one year eligible for the 60 percent capital gains exclusion. This increase in the expected return on savings would be partially, but not fully, offset by a reduction in the tax deduction available to individuals for losses on assets held between six months and 12 months. Such losses would become long-term losses and therefore would be eligible for only a 50 percent rather than a full deduction against ordinary income.

On balance, there is a net reduction in capital gains taxes, absent any behavioral change, from shortening the holding period because many taxpayers cannot fully deduct short-term losses under current law provisions. As a result, the tax reduction from converting short-term gains to long-term gains outweighs the tax increase on individuals from converting short-term losses to long-term losses. This static tax reduction means that expected after-tax returns to investors in capital assets, particularly assets that are frequently traded, such as corporate stock, will increase if the holding period is reduced. Accordingly, the incentives to save and to hold corporate stock will be improved. In addition, shortening the holding period will cause a net reduction in artificial barriers to stock transactions and thus improve the efficiency of capital markets.

Of course, any distinction between short-term and long-term transactions is arbitrary and causes distortions in market activity by encouraging investors to delay realizations of some gains until they become long-term and to advance realizations of some losses so that they qualify as short-term. Reducing the holding period from one year to six months does not address this fundamental problem. It does represent, however, a way of reducing the taxation of capital gains without introducing or increasing preferences for narrow classes of assets. Therefore, it represents a relatively efficient way of lowering the taxation of the return to saving.

We estimate that a change to the six-month holding period, effective January 1, 1984, for assets purchased after November 1, 1983, will increase Federal revenue by $38 million in Fiscal Year 1985, and reduce revenue by $201 million in Fiscal Year 1986, $200 million in Fiscal Year 1987, and $207 million in Fiscal Year 1988.

Capital losses

I earlier noted that, under current law, individuals may deduct net capital losses against $3,000 of ordinary income each year and that long-term losses are halved for the purpose of calculating this deduction. Prior to the Tax Reform Act of 1976, only $1,000 of these losses could be deducted against ordinary income. The Administration does not support proposals to restore the loss limitation to $1,000.

Some limitation on the deductibility of capital losses is necessary to prevent taxpayers who have both accrued gains and losses on different assets from claiming large deductions by recognizing losses while deferring recognition of gains. With no loss limitation, many taxpayers could show negative income from capital gains, or even negative total income, in years when their portfolios actually increase in value. In other cases, taxpayers could game the system by realizing offsetting gains and losses in alternative years, deducting losses from ordinary income while deferring tax, sometimes until the gain becomes long-term, on the offsetting gain. On the other hand, the limitation on losses can be inequitable in that it prevents taxpayers who have actually suffered losses on their entire portfolios from recognizing all their losses in the current year. For this latter group of taxpayers, any loss limitation causes their taxable income to be overstated.

The choice of a loss limitation involves balancing the need to restrict opportunities to claim large losses on portfolios with net gains with the need to allow deductions to taxpayers with net losses on their entire portfolios. The exact amount of loss limitation that would appropriately balance these competing concerns is unknown. A reduction in the loss limitation by itself would, however, reduce the expected after-tax return on investment in capital assets by increasing potential after-tax losses on unsuccessful investments. This would reduce the incentive to save. Moreover, reducing the loss limitation would have a proportionately larger effect on small savers for whom a $3,000 loss represents a much larger proportion of their total assets or income.

The $3,000 loss limitation should not be reduced simply because the holding period is reduced to six months. Reducing the holding period from one year to six months would reduce losses potentially deductible against ordinary income for some individual taxpayers but would increase such losses for other taxpayers. For individuals with no gains but with losses on assets with holding periods between six and 12 months, a reduction in the holding period would reduce potentially deductible losses since 100 percent of short-term losses, but only 50 percent of long-term losses, can be deducted against ordinary income. For other individual taxpayers, however, shortening the holding period would increase potentially deductible losses. In cases where taxpayers have both short-term and long-term net losses, the conversion of gains from short-term to long-term would increase the net short-term loss and reduce the net long-term loss, resulting in an increase in potentially deductible net losses.

A reduction in the loss limitation has been suggested as a method of offsetting the revenue loss from reducing the holding period to six months. The Treasury Department estimates that combining the two proposals would result in a net increase in revenue. As I have explained, however, there is no particular justification for reducing the capital loss limitation as a way of compensating for the small revenue loss from returning to a six-month holding period.

We estimate that, assuming a six-month holding period, reducing the limitation on deducting capital losses against ordinary income from $3,000 to $1,000 per year, effective January 1, 1984, would increase Federal revenue by $576 million in Fiscal Year 1985, $557 million in Fiscal Year 1986, $582 million in Fiscal Year 1987, and $618 million in Fiscal Year 1988.

OPTIONS AND STRADDLE TRANSACTIONS

Since the enactment of the tax straddle rules in ERTA, there have been two developments that raise important tax issues in the area of options and tax straddles. First, it has become apparent that straddle transactions in exchange-traded stock options are being used widely in abusive tax sheltering transactions. Second, trading in several new options products has commenced. These include options on regulated futures contracts ("commodity options"); cash settlement options on stock indices ("cash settlement options"); and options on debt instruments and foreign currencies ("physical options"). The tax treatment under current law of two of these products—commodity options and cash settlement options—may be subject to differing interpretations. The possible ambiguity of present law may result in tax avoidance by taxpayers who adopt the interpretation that produces the lowest tax liability when applied to their particular transactions.

In view of these developments, we believe that legislation is needed (i) to eliminate the opportunity to engage in tax shelter transactions through straddles in exchange-traded stock options and (ii) to rationalize the tax treatment of new options products where present law may be unclear.

PRESENT LAW

Taxation of straddles

Prior to the enactment of ERTA, the Internal Revenue Code did not contain statutory rules dealing specifically with straddle transactions. ERTA enacted section 1256 (the "regulated futures contract rules") and section 1092 (the "loss deferred rules") of the Internal Revenue Code, and certain other rules applicable to straddle transactions.

Regulated futures contracts

A commodity futures contract is a standardized, executory contract to purchase or to sell a specified quantity of a particular commodity at a specified time in the future at a fixed price. The contract party who will receive delivery of the commodity in the specified month (the "delivery month") upon payment of the contract price is referred to as being in a "long" position. The party who will make delivery of the commodity in the delivery month is referred to as being in a "short" position. At the close of each trading day, the clearing organization associated with the exchange on which the contract is entered into becomes the opposite party for each of the original parties to the transaction. Thus, the clearing organization becomes the purchaser for every seller of a contract and the seller for every purchaser of a contract.

Futures contracts may be settled by taking or making delivery or by taking an opposite or offsetting position in the futures market. When an offsetting position is entered into, it is paired with the original position and the positions are considered closed out. Very few futures are held to maturity; almost all are closed out by the holder's entering into an offsetting position prior to the maturity date.

A person who enters into a futures contract is not required to pay the full contract price until the delivery date. The person is, however, required to deposit original margin funds—a form of earnest money—with the broker in the amount set by the exchange. In addition to the original margin deposit, a party to a futures contract is required to put up variation margin on a daily basis if his contract declines in value. Conversely, if a contract increases in value, variation margin is credited to the party's account.

Under section 1256 all regulated futures contracts ("RFCs") are marked to market at year end. This rule applies to all RFCs without regard to whether the contract is part of a straddle. Under the mark-to-market rule, each RFC held by a taxpayer is treated as if it were closed out at its fair market value on the last business day of the taxable year. The tax basis of RFCs held on the last day of the taxable year then is adjusted to reflect gain or loss taken into account under the mark-to-market rule.

Any gain or loss on an RFC that is a capital asset in the hands of the taxpayer is treated as if 60 percent of the gain or loss were long-term and 40 percent of the gain or loss were short-term ("60/40 treatment"). This 60/40 treatment applies to both gains and losses resulting from year-end marking to market, as well as to gains and losses on contracts that are closed out during the year. Under current tax rates, the 60/40 allocation of long-term and short-term gain results in a maximum tax rate of 32 percent on gains. Gain or loss with respect to an RFC that is not a capital asset, and that is not excluded from section 1256 under the hedging exemption, is taxed under the mark-to-market system at the tax rates applicable to ordinary income.

An RFC is defined as a contract (i) with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market and (ii) which is traded on or is subject to the rules of a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission or on any other board to trade or exchange which the Secretary of the Treasury determines has rules adequate to carry out the purposes of section 1256. Certain foreign currency contracts also are treated as RFCs.

Loss deferral rule

Section 1092 governs the taxation of straddles that are not composed exclusively of RFCs. Under the loss deferral rules, the deduction of losses with respect to positions which are part of a "straddle" is limited to the amount by which such losses exceed unrealized gains on any offsetting positions. Losses deferred under the loss deferral rule are carried forward to the succeeding year and are subject to the application of the loss deferral rule in that succeeding year. Deferral losses are recognized in the first taxable year in which there is no unrealized appreciation in offsetting positions acquired before the disposition of the loss position.

A straddle is defined as offsetting "positions" with respect to actively traded personal property. Stock is not treated as personal property for this purpose. In addition, exchange-traded stock options of a type that have a maximum duration that is less than the long-term capital gain holding period are not treated as positions. Since exchange-traded stock options currently have a maximum duration of approximately nine months, all exchange-traded stock options presently are excluded from the tax straddle rules.

A taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer's risk of loss from holding one position by reason of his holding one or more other positions. Section 1092 prescribes certain circumstances in which positions are presumed to be offsetting. For example, if the aggregate margin requirement for two or more positions is less than the sum of the margin requirements for each position if held separately, the two positions are presumed to be offsetting.

Mixed straddles

If a straddle is composed partially of one or more RFCs and partially of other positions (a "mixed straddle"), losses with respect to positions that comprise the straddle are subject to the loss deferral rule. The RFCs that are part of the straddle are subject to both the loss deferral rule and the mark-to-market rule unless the taxpayer makes the mixed straddle election. If the election is made, the mark-to-market rule will not apply to RFCs which are part of the mixed straddle.

Hedging exemption

The loss deferral rule, mark-to-market and other tax straddle rules do not apply to hedging transactions. Three principal requirements must be met for the hedging exemption to apply. First, the transaction must be entered into in the normal course of the taxpayer's business, primarily in order to reduce the risk of price change, currency fluctuation, or the like. Second, the taxpayer must clearly identify the transaction as a hedging transaction before the close of the day on which the taxpayer entered into the transaction. Syndicates (entities more than 35 percent of the losses of which are allocated to limited entrepreneurs) generally are not eligible to use the hedging exemption.

Taxation of option transactions

Stock and physical options.—There are two types of option: calls and puts. The holder (or owner) of a call has the right (but not the obligation) to buy the property that is the subject of the option at any time prior to expiration of the option for a specified price referred to as the "strike" price. The holder of a put has the right (but not the obligation) to sell the optioned property to the writer at any time prior to the expiration of the put at the strike price. The holder of the option pays the writer the "option premium" for the rights conferred by the option.

The contact party opposite the holder of a put or call is the writer or grantor. The writer of a call is obligated to sell the property subject to the call at the strike price upon exercise by the holder during the term of the option. The writer of a put is obligated to buy the optioned property upon exercise of the put. The option writer's compensation for accepting these obligations is the payment of the non-refundable option premium.

Although exchange-traded option transaction initally are agreed to between the representatives of the holder and writer by means of open outcry in a trading pit, the clearing organization for the exchange is substituted as a party between the writer and holder of each option at the end of each trading day. Thus, the exchange takes the position of holder for every writer, and writer for every holder.

The rights of a holder or a writer of an option can be terminated by (i) a closing transaction (an exchange mechanism involving the acquisition of an offsetting option with the same strike price and expiration date); (ii) lapse of the option (i.e., expiration of the option period without exercise); or (iii) the exercise of the option. Upon exercise of an option by the holder, the clearing organization selects a writer of the same option (typically at random), the two options are paired, and the writer is called upon to perform under the option.

The tax treatment of option transactions generally is governed by section 1234 of the Code. Different rules apply depending upon whether the taxpayer is a holder or a writer of an option and whether the taxpayer is an investor or a dealer. I will deal first with the rules applicable to investors.

Holder of an option.—The payment of the option premium by the option holder to the writer of a put or call is a nondeductible capital expenditure. The option transaction is considered an open transaction, and no gain or loss is recognized until (i) lapse of the option, (ii) sale of the holder's rights through entry into a closing transaction executed on the exchange, or (iii) the sale of property on exercise of a put option. The purchase of property on exercise of a call option is not a recognition event for tax purposes. If a holder allows an option to lapse, the holder is deemed to have sold or exchanged the option on the expiration date. If a holder enters into a closing transaction, any resulting gain or loss is considered gain or loss from the sale or exchange of property which has the same "character" as the property underlying the option. Subject to the applicability of the short sale rules to puts, the period the option is held by the holder determines whether such gain or less is short-term or long-term. Since the long-term capital gain holding period currently is one year and exchange-traded options have a maximum term of approximately nine months, gains and losses with respect to exchange-traded options are short-term.

If a call option is exercised, the holder does not recognize gain or loss. The premium paid for the call option is included in the cost basis of the property acquired. If a put is exercised, the premium reduces the amount realized upon the sale of the underlying property. The resulting gain or loss is capital if the underlying property is a capital asset, and is short-term or long-term depending upon the holding period of the property (subject to the applicability of the short sale rules). The holding period of property acquired on exercise of a call does not include the holding period of the option.

Writer of an option.—An option writer does not recognize gain on receipt of the option premium. Since an option is considered to be an open transaction, gain or loss with respect to the option premium is not recognized until (i) the option lapses;

(ii) the obligation of the writer with respect to the option is terminated by entry into a closing transaction; or (iii) the sale of property on exercise of a call option. The purchase of property on exercise of a put is a non-recognition transaction. If the option is allowed to lapse, gain attributable to the option premium is considered short-term capital gain to the writer. Any gain or loss resulting from a closing transaction which terminates the writer's obligations under the option is treated as short-term capital gain or loss.

Upon exercise of a call option the premium is considered part of the purchase price of the property sold. Therefore, the total amount realized by the writer on the sale of the underlying property to the holder equals the premium plus the strike price of the option. The holding period of the writer with respect to gain or loss on the sale depends upon the holding period of the underlying property.

The amount of the option premium received by the writer of a put is considered to constitute a reduction of the purchase price of the underlying property for purposes of determining gain or loss in a subsequent sale of the property. The writer may not include the holding period of the option is determining the holding period of the underlying property.

Dealers.—Gain or loss from transactions in options written or acquired in the ordinary course of a taxpayer's trade or business as a market maker in options appears to be treated as ordinary income or loss. The timing of the recognition of gain or loss with respect to options transactions by market markers is the same as that discussed above in connection with investor-traded options, subject to the overriding application of the inventory accounting provisions of the Code.

Commodity options

The writer of a commodity option grants the holder the right, but not the obligation, to enter into a futures contract to purchase a designated commodity (a "long" futures contract) or to sell the designated commodity (a "short" futures contract). Under the terms of a commodity option, the holder can enter into the long or short futures contract at the strike price at any time during the option period. The writer of a commodity option is obligated to enter into the long or short futures contract if the holder exercises the option.

During the option period, the writer of a commodity option must make margin deposits in the event that the option increases in value. These deposits are equal to the difference between the strike price of the futures contract set forth in the option and the market settlement price of the futures contract. In the event of a subsequent market decline, the writer may receive back part or all of the deposit paid previously. If the option is exercised, the parties enter into the specified futures contract and the total margin deposit made by the writer is paid to the holder of the option.

As an example, consider a commodity call option contract written for a $10 premium with a strike price of $100. Assume the market settlement price for the underlying futures contract rises to $180, and the holder exercises the option. The holder and the writer of the call then are obligated to enter into a futures contact at $100. The writer of the option retains the $10 premium; however, the writer has been required to provide margin deposits equal to the difference between the strike price of the option and the market settlement price of the futures contract ($180 − $100 = $80). The $80 is paid to the holder of the option at the time it is exercised.

In our view, commodity options are taxed under the same rules that apply to physical options. As a result, a discontinuity exists in the tax treatment of commodity options and the underlying RFCs because the exercise of an option is a non-recognition event. If a taxpayer has unrealized gain on an option, he can acquire the underlying futures contract by exercising the option (or, if he is an option writer, by allowing the option to be exercised). On the subsequent disposition of the futures contract, the taxpayer apparently will receive 60/40 treatment, resulting in a maximum rate of tax of 32 percent on the entire transaction, including the accrued gain on the option. If, on the other hand, the taxpayer has a loss on a commodity option, he can enter into a closing transaction or allow the option to lapse, thereby producing a short-term capital loss which gives rise to tax benefits at a 50 percent maximum rate.

It has been suggested that this discontinuity in the taxation of commodity option transactions can be avoided by treating the exercise of a commodity option as a recognition event for tax purposes, or by mechanically segregating option gain or loss from subsequently accruing gain or loss on the futures contract. Either approach would function to prevent taxpayers from converting short-term gain to 60/40 gain by means of exercising a commodity option. It is doubtful, however, that either approach can be substained under current law.

Some persons have expressed the view that commodity option gains and losses are taxed in the same manner as RFCs under present law. These persons contend that a commodity option actually constitutes a regulated futures contract with respect to the writer of the option because the writer must make (and may receive back) margin deposits based on fluctuations in value of the option, and because commodity options are traded on a board of trade designated by the Commodity Futures Trading Commission. Thus, it is contended that the two elements of the statutory definition of an RFC are met with respect to a writer of a commodity option. In the case of a holder of a commodity option, it is contended that RFC treatment is required under the "look through" rule for options embodied in section 1234(a)(1). Under that rule, gain or loss on an option is treated as gain or loss from the sale or exchange of property which has the same "character" as the property underlying the option. The assertion is the "character" of the underlying RFC includes the 60/40 treatment accorded investors in RFCs. Irrespective of policy considerations that may favor this result, we believe that this interpretation of current law cannot be sustained under the present statute.

Cash settlement options

Options on certain indices—such as composites of all of the stocks trading on a given exchange—are settled in cash, because it is not practicable to deliver each of the shares comprising the index upon exercise of the option. The option contract instead provides that on exercise of the option, the writer must pay the holder of the option an amount of cash that is computed by reference to the level of the index.

The tax treatment of cash settlement options under present law may be subject to question. Section 1234, which governs the tax treatment of options generally, provides rules applicable with respect to "an option to buy or sell property" and, in the case of a grantor, for "an option in property." It is not clear whether these rules apply where an option provides for delivery of an amount of cash determined by reference to the value of certain property, instead of providing for actual delivery of property.

If section 1234 is not applicable, a closing transaction with respect to a cash settlement option is likely to be viewed as giving rise to capital gain or loss to an option holder under the general rules applicable to the sale or exchange of a capital asset. The exercise or lapse of an option, or a closing transaction in the case of an option written by the taxpayer, would not constitute a sale or exchange, but nonetheless appears to result in capital gain or loss under section 1234A. That section provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property which is (or would be) a capital asset in the hands of the taxpayer is treated as gain or loss from the sale of a capital asset.

LEGISLATIVE PROPOSAL OF CHICAGO BOARD OPTIONS EXCHANGE, INC.

The Chicago Board Options Exchange, Inc. ("CBOE") has made a proposal to deal comprehensively with problems presented by tax straddling in stock options and uncertainty concerning the tax treatment of commodity and cash settlement options. The proposal contains the following elements: (i) the exemption from the tax straddle rules for stock options (and for stock, where it is part of a straddle with a stock option) would be repealed; (ii) the current rules governing option transactions would be modified so that cash settlement options and commodity options would be subject to symmetrical rules that parallel the treatment of stock options; (iii) exchange-traded options (including stock options, physical options, cash settlement options and commodity options) would be subject to the mark-to-market and the 60/40 rules provided for regulated futures contracts in ERTA; (iv) capital, instead of ordinary, treatment would be provided for options market makers; and (v) an exception to the straddle rules would be provided for covered call writing transactions where the call is not written deep-in-the money.

DISCUSSION

The CBOE proposal represents a thoughful and responsible analysis of the problems in this area that face both the Government and the industry. We agree with parts of the proposal, but we are unable to support it in its entirety.

Stock and stock options

As discussed above, exchange-traded stock options are not subject to the tax straddle rules. This exemption was provided in ERTA because it was believed that stock options were not used in straddle transactions.

Since the enactment of ERTA, we have seen substantial indications that taxpayers are attempting to defer the taxation of income through tax straddles in exchange-traded stock options. These transactions have taken two forms:

Limited partnerships of investors claim to be acting as market makers in stock options. Straddle transactions in stock options are undertaken to produce losses, which are passed through to investors as ordinary losses.

Investors take offsetting positions in stock options—typically deep-in-the-money options which have a smaller time premium and more nearly parallel response to price fluctuations in the underlying stock—to defer short-term capital gains by taking the short-term capital loss on the loss leg of the straddle.

Structurally, stock option tax straddles closely parallel the straddle transactions in commodity futures that were barred by ERTA. Even though the straddle rules of ERTA do not apply to these transactions, the transactions are subject to challenge by the Internal Revenue Service under Rev. Rul. 77-185, 1977-1 C.B. 48. In one Tax Court case, the court disallowed commodity straddle losses due to the absence of a profit motive. *Smith* v. *Commissioner,* 78 T.C. 350 (1982).

A typical stock option straddle transaction would be the following:

"Shares of T Corp. stock are trading at $75. On December 1, X buys a T Corp. May 35 call option and simultaneously writes a T Corp. May 40 call option. The premium required to be paid on the May 35 call is $41, while the premium to be received on the May 40 call is $36. T stock subsequently rises to $85. At the same time, the May 35 call increases in value from $41 to $51, and the May 40 call increases in value from $36 to $46. X closes out the May 40 call at a loss of $10 and immediately writes a May 45 call, for $41. Thus, in year 1, X recognizes a loss of $10. In addition, at the end of year 1, X has unrealized gain in the May 35 call of $10. T stock does not subsequently change in value. On January 2, X closes out the May 35 call at a profit of $10, and the May 45 call for no gain or loss. Thus, in year 2, X recognizes the $10 gain that matches the $10 loss recognized in year 1.

"If, on the other hand, T stock had declined in value, X would have experienced a loss on the long May 35 call, and a corresponding gain on the short May 40 call with the result that the straddle loss would have been claimed on the long side. Thus, irrespective of the direction in which the market moved, X would have been able to produce a tax loss without material risk or cost (other than transaction costs)."

In our view, the ability to defer substantial amounts of income through essentially riskless transactions in stock options is just as objectionable as the straddling in regulated futures contracts and other actively traded property that occurred prior to enactment of the straddle provisions in ERTA. The deferral of tax liability claimed to be achieved through these transactions is, in substance, an interest-free loan of the deferred tax from the Government. Alternatively, such deferral can be viewed as an actual reduction of tax liability as a result of the time value of money. This deferral can be continued through the use of similar transactions in subsequent years. We therefore urge the Congress to enact legislation to remove the exemption for exchange-traded stock options from the tax straddle rules. To deal with the case where a straddle consists of a stock option and stock, we would favor treating stock (which is never a "position" that may give rise to a straddle under current law) as a position where it is offset by a stock option.

Such legislation would end the possible opportunity for investors to shelter income from tax through stock option straddles. It also would prevent "syndicates" (entities in which more than 35 percent of the losses are allocated to limited entrepreneurs) from attempting to defer ordinary income through stock option straddles because syndicates are not eligible to use the hedging exemption from the straddle rules.

Commodity options

Because commodity options and the RFCs that underlie such options are taxed at different rates, and because exercise of an option is a non-recognition event for tax purposes, taxpayers apparently are able to obtain unintended tax benefits with respect to transactions in commodity options. Taxpayers with gains can exercise their options and, it appears, receive 60/40 treatment on the gain, including the portion attributable to the option, whereas taxpayers with losses may close out the option to produce short-term loss. The position of some taxpayers that commodity options receive 60/40 treatment under current law also creates an opportunity for taxpayers to whipsaw the Government. Taxpayers with gains from transactions in commodity options may claim that they are entitled to 60/40 treatment while taxpayers with losses may claim that the tax rules generally applicable to options entitle them to short-term capital loss treatment (although year-to-year consistency of position would be required).

Prompt legislation is essential to end the opportunities that currently exist for taxpayers to obtain a reduced rate of tax through selective exercise of commodity options, and to whipsaw the Government by claiming inconsistent tax treatment. Treasury believes legislation that would threat commodity options in the same manner as RFCs is the most desirable solution for a number of reasons.

First, taxing commodity options in the same manner as RFCs would eliminate automatically the possible opportunity for taxpayers to have gains taxed at a maximum rate of 32 percent by exercising profitable options and to have losses taxed as short-term capital losses by offsetting options that have depreciated. This result occurs because the option and the underlying property would be subject to the same rate of tax.

Second, such a rule would reduce significantly complications created by mixed straddles. Because commodity options and regulated futures contracts are traded on the same exchanges, taxpayers can readily enter into straddles composed of a commodity option and an offsetting RFC. Although we have no firm empirical evidence, it appears likely that such straddles occur frequently. If commodity options are not treated as RFCs, such straddles would constitute mixed straddles. Thus, it would be necessary to apply the rules of section 1092 to such transactions. These rules present two primary difficulties. Initially, it must be determined whether the commodity option and RFC position constitute a straddle. This determination requires assessment of the risk reduction associated with the combination of positions. In addition, application of the short sale rules under section 1092(b) is required in certain circumstances, such as where a commodity option/RFC straddle results in short-term loss and 60/40 gain. Application of these rules presents complex questions for both taxpayers and the Internal Revenue Service.

According RFC treatment to commodity options automatically eliminates the need to apply section 1092 to commodity option/RFC staddles. We believe that it is desirable as a policy matter to avoid a large incidence of mixed staddles where possible.

Third, the treatment of commodity options as RFCs is consistent with the general statutory scheme applicable to options. In general, under current tax rules, the manner of taxing gain or loss attributable to an option transaction parallels the taxation of a transaction in the property to which the option relates. This statutory scheme eliminates tax arbitrage opportunities through exercise of an option—the problem that is now presented with respect to commodity options. The rules in section 1234 were enacted to deal with similar tax arbitrage problems. We think this approach is a desirable means of dealing with the apparent tax arbitrage opportunity presented by transactions in commodity options.

We note that the tax arbitrage opportunity that apparently is available to taxpayers with respect to transactions in commodity options also could be foreclosed by treating the exercise of the option as a recognition event for tax purposes. Such a rule would be inconsistent with the general tax treatment of options transactions. Different treatment for commodity options could be justified, however, because—unlike exercise of other options—exercise of commodity options results in a distribution of cash as variation margin on the underlying future. The amount of the variation margin corresponds closely to an amount realized on the option transaction. Nevertheless, the policy considerations discussed above lead to the conclusion that RFC treatment for commodity options is a better solution.

Cash settlement index options

Treasury also supports legislation to amend section 1234 to clarify that an investor receives capital gain or loss treatment on transactions in cash settlement options, and that a dealer in such options is governed by the same rules that apply to dealers in other options.

The economic and mechanical characteristics of transactions in cash settlement options are essentially the same as those of transactions in stock options or physical options, except that instead of requiring delivery of property on exercise, the option provides for payment of an amount of cash corresponding to the value of the underlying property. While the cash settlement feature may raise technical questions as to whether the rules currently applicable to option generally apply to cash settlement options, we do not think there is a policy reason that would justify different treatment. A similar amendment was made to section 1256 by the Technical Corrections Act of 1982 to bring definition of an RFC.

Extension of section 1256 to exchange-traded options

Under the legislative proposal of the CBOE, transactions in exchange-traded options would be taxed under the mark-to-market and 60/40 rules of section 1256. This change would extend to stock options, physical options, commodity options and cash settlement options. Treasury is opposed to extending the rules of section 1256 to all exchange-traded options.

We begin by observing that RFC treatment embodies two separate and distinct rules. (i) RFCs are marked to market at year-end; and (ii) gains and losses on RFCs are taxed under the 60/40 rule. The desirability of expanding the two components of RFC treatment must be analyzed independently.

Looking first to mark-to-market accounting concept, it is clear that the primary advantage of the mark-to-market rule over the loss deferral rule is that year-end marking to market obviates the need to identify offsetting positions that comprise a straddle. When taxpayers have large volumes of trades, the identification of straddles can be difficult for both taxpayers and the Internal Revenue Service. Moreover, in the options area, identification of straddles is complicated in some cases by the fact that offsetting positions are not always in a one-to-one ratio.

Where a taxpayer enters into a mixed straddle (i.e., a straddle that consists of an RFC and a position that is not an RFC), the advantage of the mark-to-market rule is lost because it is only applicable to one position of the straddle. Consequently, the mark-to-market rules do not function to prevent straddling where only one leg of the straddle is subject to the mark-to-market rules. The loss deferral rules also would need to be applied to this situation. We understand that investors in stock options frequently will have mixed straddles as a result of investments in stock. As a result, the benefit of mark-to-market treatment for these options is undermined significantly.

Turning then to the application of the 60/40 rules to options (other than commodity options), complications again arise because of the likely proliferation of mixed straddles. Initially, when a taxpayer holds a mixed straddle, he must determine the advisability of making the mixed straddle election to avoid having the RFC leg of the straddle taxed under the section 1256 rules. In addition, the applicability of 60/40 treatment to only one leg of the straddle (where the mixed straddle election is not made) in some cases necessitates application of the short sale rules of section 1092(b). In futures trading, the incidence of mixed straddles appears to be limited. Further, the need to apply the complex mixed straddle rules is confined to a relatively small group of sophisticated investors. Because of these factors, the applicability of the mixed straddle rules is manageable under existing law which applies principally to transactions in futures.

In the context of trading in options, the presence of mixed straddles appears to pose a relatively serious problem. First, it appears that the incidence of mixed straddles would be significantly greater in options trading than in futures trading. Moreover, we are concerned that the need to apply the mixed straddle rules in the context of options trading may result in an unacceptable level of complexity for small investors, and require a high level of audit activity by the IRS. As discussed above, the desire to avoid mixed straddles where possible motivated our desire to provide RFC treatment for commodity options. The same reasoning leads us to question seriously the desirability of introducing many new mixed straddle transactions in the context of stock and other options.

Aside from our concerns regarding the proliferation of mixed straddles if options other than commodity options were accorded RFC treatment, we see no policy justification for treating 60 percent of the gain (or loss) on such transactions as long-term, without regard to the actual holding period of the option. Prior to the enactment of the straddle rules in ERTA, a six-month holding period applied to futures contracts. A substantial portion of gains on futures contracts was taxed at long-term rates (although straddling to achieve such results was and remains subject to challenge by the IRS). Transactions in options, however, never give rise to long-term capital gain (or loss) under current law. We recognize that some option transactions could qualify for long-term treatment if the long-term holding period is reduced to six months. However, the option transactions at issue do not present a situation where adoption of a mark-to-market system of taxation without a concurrent rate reduction would have the effect of increasing the tax rate on options transactions.

Treasury also believes that providing a special rate of tax for a limited category of investments raises a very fundamental tax policy question. Some persons contend that options should be provided the same tax treatment as futures because the two types of products are economically comparable. We recognize that options and futures may in some circumstances serve similar economic functions for investors, and that the disparate tax treatment of these investments may place the options industry at a competitive disadvantage. It is clearly not desirable for tax rules to cause competitive imbalance between competing industries. Nevertheless, we are not satisfied that extension of 60/40 treatment to all options products is an acceptable solution. The difficulty with extending 60/40 treatment to all options on the ground that they are comparable to futures is that this argument could be expanded incrementally to justify 60/40 treatment for virtually all investments. Particularly since stock index futures and bond futures now receive 60/40 treatment, the logical result of an effort to provide similar treatment for all investment products that could be considered comparable would be to tax all transactions in stocks, bonds and many other assets at 60/40 rates. Obviously, a basic restructuring of the taxation of capital transactions would be involved.

Finally, we recognize that providing 60/40 treatment for options and futures would have little revenue impact because the options markets, like the futures market, are "zero sum" markets. Stated differently, the structure of these markets is such that every dollar gained in these markets results in a dollar lost. Thus, the reduction of tax rates applicable to gains and losses occurring on these exchanges results in a net revenue loss only because of limitations on the deductibility of capital losses. Nevertheless, providing a special tax rate for a limited class of investments results in favored status for individual taxpayers who have gains on those investments. Unique circumstances relating to the historical treatment of futures transactions made it appropriate in ERTA to provide 60/40 treatment for RFCs. In our view, similar circumstances do not exist with respect to the options products at issue.

Mark-to-market treatment of options market makers

The CBOE proposal would extend mark-to-market treatment for options transactions both to investors in options as well as options market makers. Although we are not persuaded of the value of mark-to-market treatment for investors we think the Congress should consider carefully a requirement that options market makers employ a mark-to-market system of accounting. The evidence available to us indicates that market makers attempt to defer very substantial amounts of income through straddle transactions in options. Because market makers enter into thousands of transactions in a year, it frequently may be difficult for both taxpayers and the IRS to identify offsetting options positions and to apply the loss deferral rule. Moreover, options market makers are exempted from the tax straddle rules with respect to transactions entered into for the purpose of maintaining a hedged position.

We note that market makers currently use a mark-to-market system of accounting for a number of financial and regulatory purposes. The common use of mark-to-market accounting for non-tax purposes indicates that this method of accounting may be the most appropriate means of measuring the taxable income of these persons. A mark-to-market system of accounting thus appears to be an appropriate means of ending the deferral of taxes through use of straddles by market makers.

While we think serious consideration should be given to taxing options market makers under a mark-to-market system, we do not believe that extension of 60/40 treatment to options market makers is justifiable or desirable. Options market makers now derive ordinary income treatment from their transactions in instruments that are closely similar to inventory property. Thus, there appears to be no policy justification for providing a reduced rate of tax on such transactions.

Covered call transactions

The CBOE proposal would exclude from the definition of a "straddle" certain covered call transactions. (A parallel rule also would be provided for puts that are written in connection with short positions in the underlying property.) The following is a typical covered call transaction:

Individual A owns 100 shares of X Corp. stock. Stock of X Corp. is trading at $50. A writes a call with a strike price of $50 on 100 shares of X Corp. stock, receiving an option premium of $4.

If the price of X Corp. stock rises above the $50 strike price, the holder will exercise the call option. Upon exercise, A, the writer of the call, must deliver his X Corp. shares. If A wishes to continue his investment in X Corp. stock, he may terminate his obligation under the call by entering into a closing transaction prior to exercise of the option. Because the price of the stock has risen, A will realize a loss on the closing transaction. However, because A's stock will have increased in value by an amount exceeding the loss on the call, A will have an overall net profit on the covered call transaction. The repeal of the exemption for stock options from the straddle rules and the treatment of stock as a "position" were it is offset by a stock option would result in covered call transactions meeting the definitional requirements of a "straddle." Thus, in the example, A's loss on closing out the option would be deferred until such time as A recognized the offsetting gain on the stock.

Proponents of an exemption for covered call transactions contend that such transactions generally should not be treated as straddles because the taxpayer's risk of loss on the stock is not substantially diminished by the call. (It is conceded that the writer of a covered call which is deep-in-the-money has relatively completed protection against loss in the event of a market decline, and that it is appropriate to treat that transaction as a straddle subject to the loss deferral rules.) The taxpayer's risk of loss on the stock side is reduced only to the extent of the call premium; a loss on the stock that exceeds the call premium is not "protected." If the call is not written in-the-money, the option premium will be relatively small and the taxpayer's protection against loss also will be relatively small.

Proponents of a covered call transaction exemption also contend that it is inappropriate to apply the tax straddle rules to such transactions on the ground that the transactions are not tax-motivated. In general, the tax straddle rules of ERTA were designed to prevent distortions in the computation of taxable income that can arise from straddle transactions. Obviously, this policy exists irrespective of the taxpayer's motivation for the transaction. For these reasons, the tax straddle rules of ERTA provide an objective definition of a straddle, and a system of accounting for straddle transactions—i.e., transactions having multiple components in which the same market movement simultaneously produces a loss and a gain. This accounting treatment is appropriate irrespective of the taxpayer's motivation for entering into the transaction. Thus, in fact, ERTA recognized that mulitple component transactions having offsetting gain and losses frequently would be entered into for sound business or investment purposes.

Nevertheless, assuming that a given category of covered call writing transactions involving stock could be shown not to be tax motivated, we believe that there may be good policy reasons not to extend the tax straddle rules to such transactions. As we understand it, covered call writing is a longstanding and bona fide investment strategy that is widely utilized. Given the accepted role of such transactions in the investment community, we are concerned with the possible disruption that could result if the tax straddle rules were newly applied to such transactions. We wish to emphaisze that an exception to the proposed extension of the tax straddle rules for covered call writing transactions would be justified by the unique circumstances presented with respect to these transactions. We would resist strongly any effort to create other exceptions to these rules.

Although our analysis assumes the existence of a category of covered call transactions that is not tax-motivated, we do not have sufficient information at this time to formulate a rule that would identify such transactions. The CBOE has suggested that a call should not be made subject to the straddle rules if the strike price of the option is in excess of 85 percent of the trading price of the underlying property. Our preliminary review indicates that such a standard is too broad a measure of downside risk protection, and that it may offer taxpayers substantial opportunities to engage in virtually riskless transactions without running afoul of the rule. We would like to work with the Committee and the financial community in developing a standard that will identify covered call writing transactions that are not tax-motivated. Assuming that a satisfactory standard can be devised, we think the tax straddle rules should not be extended to cover such transactions.

This concludes my prepared remarks. I will be happy to respond to any questions that you may have.

Mr. PICKLE. Mr. Chapoton, I did not state at the beginning that your entire statement will be included in the record, and of course it will be. I thank you for your testimony. Now, I notice that you testified that you would support the reduction of the holding period, that you could support that and accept the revenue loss.

Mr. CHAPOTON. Yes, sir.

Mr. PICKLE. But you testify that you would not recommend the reduction of the capital loss limitation from $3,000 to $1,000.

Mr. CHAPOTON. That is correct.

Mr. PICKLE. Now to make the holdings period revenue-neutral, what would you recommend as a means of raising these additional funds?

Mr. **Chapoton**. Mr. Chairman, we are not making a recommendation in that regard. This long-term capital gains holding period, 6-month holding period, has been discussed for a number of years. We have spent a lot of time on it in the last 2½ years since we have been here.

We think it is a desirable change. It will reduce slightly, because there is this revenue loss, reduce slightly the tax on savings that are held in this form. We think it will reduce but not remove an artificiality in the market. It changes it from 12 to 6 months. We think that is a desirable change. We are supporting it.

I think it is probably not wise to try to offset this change against a revenue raising change to pay for it. It is a relatively small amount of money. Indeed, in the first year if you have a prospective effective date it is a slight revenue increase and a small loss in the years after that, so I think we would say that it ought to be viewed in the overall context of a tax bill and without trying to have an offsetting increase.

Mr. **Pickle**. Well, Mr. Chapoton, Chairman Rostenkowski has asked us to raise a question. Are there more appropriate means of making up this revenue loss? And he has specifically asked that you comment on the tax sheltering opportunities that you discussed in your testimony when you appeared before the Senate Finance Committee?

As I understand it, you testified before that committee about such schemes as selling stock short just before the stock pays a dividend as well as a number of problems in the partnership area involving the so-called allocation rules.

Mr. **Chapoton**. I think there are several sheltering matters that we have brought to the attention of this committee and to the Finance Committee, and we certainly would support and have supported making those changes, and indeed it might be wise to couple that change with this change.

Mr. **Pickle**. Do you have any other suggestions, because I think there is general agreement that the 6-month reduction period is acceptable; now we need to look at some alternative so that it is not a deficit matter. Do you have any other suggestions?

Mr. **Chapoton**. Well, we could pull out the broad range of anti-tax shelter provisions that we have suggested, some of which have not been acted upon by the Finance Committee or this committee, and we could certainly come forward with those. I do not have them at hand, but we have supported them, and they would raise some money.

Mr. **Pickle**. Well, we would like some official figures submitted to the committee.

Mr. **Chapoton**. That would be fine. We would be happy to supply those.

Mr. **Pickle**. So that we will know what the result is if we take that approach.

Mr. Stark.

Mr. **Stark**. Buck, I am sorry to miss the main part of your testimony, but as you heard earlier I was hoping to make some distinction between collectibles and productive assets, and I heard a vague reference to not raising any revenue in this bill. Is that what you were referring to? Or would there be some simple ways that we could define nonproductive assets and either keep them in a longer holding period or not give them capital gains treatment at all?

Mr. CHAPOTON. I have not looked at the revenue figures on that type of change, Mr. Stark. I think the problem you are wrestling with is one that we have discussed in the past. The question is whether you expend money for a collectible, is that savings or is that current consumption.

When you discuss that with the economists I think what you finally come out with—well, to the extent that it is savings, it is hard to say that they should not receive, that that asset should not receive the same rate as other capital assets. It is savings in a form that will appreciate.

To the extent that it is consumption, a different analysis would apply. You come out probably in most cases it is part savings and part consumption, but it is going to be difficult to start drawing the line between certain types of capital assets. You can do it and it would be arbitrary, but then you have got—you have to be careful that you are not taxing, I think you would not want to tax savings at a higher rate.

And so you would be trying to select those where you are pretty sure that it is almost all or most, a majority of the investment would be considered current consumption. Does he put the oriental rug on the floor or does he put it in a vault?

And then you also have the question whether you can identify a category of assets that are not going to receive the favorable treatment. What if you have stock in a company that holds those assets? Do you look through the stock and say well, the stock, then, does not receive capital treatment? I think we would run into a lot of problems.

Mr. STARK. I suppose that the company who holds those assets, if it is not trade or business, if they are a dealer, a rug dealer, for instance, that is inventory and not entitled to capital gains. But I guess the question is, from the standpoint of enforcement, it is my understanding that there are some real problems now both in appraising and in reporting in the question of collectibles, particularly precious metals.

So are there some areas that the Service would recommend to tighten up regulations or reporting requirements that would just bring the current traffic in those items under the present tax even if we lower the holding period?

Mr. CHAPOTON. The compliance is definitely a problem. We do not have reporting in most of those areas and we have looked at the possibility of—well, I think we have the authority, Mr. Stark, to extend reporting under the provisions of TEFRA. We have not done so for the collectibles.

The problem we ran into—and we are still reviewing it—is do you have some reports by markets? That would be easy enough, but how about dealers and how about the people who are really not dealers? You have difficulty drawing the line on who has to report and who does not have to report. But it is a problem I can see, and it is one that should not be ignored.

Mr. STARK. Would there be any real difference, in your opinion, seeing as the testimony, a lot of testimony we received is that if you sell a collectible or a nonproductive asset that that money may then go into a productive asset and, therefore, if you follow that extension all you are really saying is why don't we lower the tax rate.

Any lowering of the tax rate would encourage investment. Would it not then be easier to enforce and simpler to merely lower the tax rate on ordinary income a half a percent or whatever would be needed to accomplish the same thing and not worry about fussing around with the capital gains period?

Mr. CHAPOTON. Well, I think the comparable situation that you would describe would be lowering the rate of tax generally on savings.

Mr. STARK. No. In other words, if you follow the logic that any extra money, discretionary after-tax income, is apt to maybe, possibly find its way into capital investment, therefore that is good for productivity, then it seems to me you get exactly the same effect by dropping that top rate from 50 to 49.5—the same amount of revenue loss or tax savings. It goes to rich people, the same as this bill does, but it gives them a shot at getting more money, basically, from all sources to invest in these productive assets.

Mr. CHAPOTON. I think the analysis would be that if you lower the rate on savings, on income from savings then you encourage savings as contrasted with lowering the rate on all forms of income. I see your point, that some of that would spill over into savings. Some of it is going to spill over into consumption, but I believe the comparable situation would simply be lowering the rate on all savings, which would be ordinary income from savings as well as capital gains from savings and clearly that would be a reasonable alternative to dealing with the capital asset area.

Mr. STARK. It seems to me it would be much simpler, that is all. If you assume that the people with the 50-percent marginal rate are the ones who have the most discretionary after-tax income with which to invest, and that is what you want to encourage, why fuss around with the capital gains at all? Why not just lower the rate or adjust the rate up a little and eliminate the capital gain and the holding period entirely?

If this is where that argument leads, and nobody has put it any other way, then I say why don't we either lower or increase that highest marginal rate because nobody seems to say that this bill encourages investment. It just gives people more after-tax dollars and they probably will invest.

Mr. CHAPOTON. No; I think that to the extent the bill lowers the tax on capital appreciation—it does—that is clearly a form of income from savings and it is clearly lowering the tax on savings.

Mr. STARK. I have a hunch that we have come up against it because I think you and I understand that most of these people in the high brackets do not get anywhere near 20 percent effective rate anyway.

Mr. CHAPOTON. Well, certainly when you look at the figures, Mr. Stark, in the higher brackets the system is progressive.

Mr. STARK. Thank you.

Mr. PICKLE. Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman.

Mr. Secretary, I would like to talk to you just briefly about two things. One is the revenue, alleged revenue loss, and the other is the question of loss carryback. Probably more important one right now is the question of revenue because most everybody on the committee seems to favor reducing the holding period. But the only hangup is the so-called revenue loss.

As I read your testimony, the Treasury says we will have no revenue loss in 1984.

Mr. CHAPOTON. Right.

Mr. ARCHER. The Treasury says we will have a gain of $38 million. I am speaking only now of the reduction in the holding period, nothing else that we are dealing with. So we will actually have a gain of $38 million in revenue in fiscal year 1985. Did I read your testimony correctly?

Mr. CHAPOTON. That is correct.

Mr. ARCHER. And that in the outyears, 1986 and 1987, you allege that there will be higher revenue losses. But the total for the 3-year period that we are looking at—1984, 1985, and 1986—you estimate a revenue loss in the aggregate of $163 billion.

Mr. CHAPOTON. Million.

Mr. ARCHER. I am sorry—million, yes. Thank you very much. I guess we would not even be here talking about it if it were billions.

The joint committee, on the other hand, alleges that there will be a revenue loss of $390 million. That is $227 million more than the Treasury. Now there has got to be some massive discrepancy when we have that kind of difference in estimates of revenue loss. I am just wondering if both of you might not be inaccurate.

We were told in 1978 when we reduced the capital gains tax that we would have massive revenue losses. In fact, as I understand the Treasury study, we actually had gains in revenue in the 3 years thereafter.

Mr. CHAPOTON. That is correct.

Mr. ARCHER. Why do you now think that as a result of this we are going to have any revenue loss? You at least seem to be more optimistic than the joint committee because you show a revenue pickup in 1985 of $38 million.

Mr. CHAPOTON. Mr. Archer, I doubt that we are in disagreement with the joint committee. I think the difference is probably the effective date. Our estimate is on totally prospective new purchases after the date of enactment. I believe their's may be with respect to any sales after the effective date. I will have to verify that.

Mr. ARCHER. Even so, there are massive differences. If you equate 1985 on their revenue estimates to your 1986, which would be taking into account a difference in effective dates, joint committee has $140 and you have got $201. There is no similarity between the revenue estimates in any way, shape or form. We heard testimony over and over again from the Treasury and the joint committee staff in 1978 that we were going to have these massive revenue losses if we reduced the tax on capital gains. In fact those of us who alleged there would be a revenue pickup were pooh-poohed, but we were right.

Now, there is every bit of empirical evidence to show that we will have a revenue pickup from this. If this is the only basis on which we are arguing or debating this issue, we should look at experience rather than conjecture—conjecture that followed a wrong path in 1978.

I only make that point because I do not guess—it is a judgment call. Do you wish to comment on it quickly; I would like, however, to get to the other issue, too.

Mr. CHAPOTON. Let me make a couple of points. One, what happened in 1978 was a reduction in rates. This is not a reduction in rates. So it is a different situation. It is not an easy analysis because we could all do it if we just took the present pattern of transactions and applied new rates or new holding periods to that.

But we know that there will be changes. So you have to anticipate behavioral change, 1978 clearly did not anticipate, first, the acceleration of the unlocking effect that occurred—and it did certainly occur—but in addition you are perfectly correct. There was the suggestion, the statement, that it would be a permanent loss. It looks like now there is a small permanent increase in addition to the acceleration effect.

When you turn that to this proposal, clearly some acceleration effect, if you will, some gains will be realized at the end of 6 months that would have otherwise been realized at the end of 13 months or at the end of 12 months.

But you have to recognize that on this transaction the Treasury is on both sides of the transaction. We do not care whether A or B holds the stock. If A gets out at the end of 6 months and the stock goes down and B buys it and then B realizes the loss, we are indifferent whether A or B realizes it. We are then recognizing the offsetting loss at a later time.

But I would just say that the very fact that there is a small revenue impact does mean that it is more favorable to the investment climate.

Mr. ARCHER. Well, let me quickly, before I run out of time, discuss loss carryback because there is no provision in the current law for a capital loss carryback. You have some very, very bizarre situations that occur out there with people who are not wealthy but people who do become investors in the market. For example, they take a major gain in one year and, even before the tax liability comes in the next year, have a massive loss and are unable to pay the tax on the gain they had the previous year.

There are instances that have been called to my attention. One extremely bizarre incident involved an individual who committed suicide because of this unfair application of the law. That is, the person experienced a massive tax gain in 1 year, a massive tax loss in the first 3 months of the next year. The inability to pay the taxes that destroyed this individual's life, and I think unfairly.

I wonder what the Treasury's position would be in permitting a loss carryback in that kind of a situation.

Mr. CHAPOTON. Mr. Archer, offhand—and I really have not thought about this too much—but offhand I see some logic certainly in what you are saying. You would be talking about a carryback to the extent of capital gains.

Mr. ARCHER. That is right.

Mr. CHAPOTON. I think we could certainly look at that. In some cases taxpayers would rather not have the carryback and use the full amount against ordinary income in the current year, but I can see the logic, certainly, in what you are saying.

Mr. ARCHER. I would appreciate it if you would give us some input on that.

Thank you very much, Mr. Chairman.

Mr. PICKLE. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. Secretary, I must admit that I would like to just reinforce what Mr. Archer said, for he actually stole my opening question. I would emphasize that I am only one of many representatives in Congress who has been trying to reduce the holding period.

My bill, H.R. 2225, has over 200 cosponsors, 17 members of the Ways and Means, the minority leader, the majority leader, the minority whip, and the majority whip. So there are over 200 Members of Congress that now agree with your position that we ought to do this without trying to find the revenue.

But the problem that I have run into legislatively is that we have this huge deficit and the chairman and other members desire a revenue-positive bill. The recommendation that I would like to leave with the Treasury is to rethink that $200 million loss and see if you could not take your statement on page 3, where it says "absent any behavioral change" and go on and admit that an investor is not static and that they will respond to tax changes. As a result of what Mr. Archer said—and just so the record will be very clear, here is the information we received from your own office, contrary to the prediction that it would have a revenue loss, you had $11.7 billion in 1979, $12.5 billion in 1980, $12.4 billion in 1981.

So there was that increase, and the increase that you now say that should be——

Mr. CHAPOTON. From the 1978 changes?

Mr. ANTHONY. From the 1978 changes.

Mr. CHAPOTON. Mr. Anthony, let me say that the statement in the testimony that you are referring to—"absent any behavioral change"—is a lead-in to the discussion. Certainly our revenue estimates contemplate and anticipate behavioral change. It is not— We have spent a lot of time on the question of whether it is a revenue loss. I would emphasize that that is a different question than reducing the rate. When you reduce the rate, you clearly have other impacts that is quite different than reducing the holding period.

So the analysis has to proceed on both when realized gains and losses will occur. The thing we always forget about in this is that the limitation of capital losses means that taxpayers are taxed on the up side but do not get the full benefit on the down side, so the effect on losses is an important factor here.

Now we have met with the Securities Industry Association and others interested in this. We think our revenue estimates are sound, but I would emphasize that they are very, very minor, as you can see.

Mr. ANTHONY. Well, I appreciate Treasury coming in and supporting my original provision. As a matter of fact, that would be my preference, but in order to get it as far as we have gotten to today we had to find some way to make it absolutely revenue-positive, even with all of the warts that this change brings.

What I enjoy most is reading page 3 where you say that there is an arbitrary distinction between short term and long term, and really there should not be a holding period at all. I want you to know that that is my fallback position. Maybe we could reduce the holding period all the way down to just whatever recordkeeping period it would take to clear the transactions, and thus have the United States join with the rest of the free world in the way it treats capital formation.

But I know politically we are not going to get that done. So if Treasury could work very hard with us, maybe we could get the original proposal passed and at least, barring that, do not give us too much opposition in passing it in its amended form. This is going to be revenue-positive and will help capital formation all the way around.

But I thank you for your support of the original proposal.

Mr. PICKLE. Mr. Guarini.

Mr. GUARINI. Thank you.

Traditionally, Buck, as I remember the law for decades it was a 6-month holding period and the $1,000 figure may have been used at that time as the deduction limit.

Mr. CHAPOTON. That is correct.

Mr. GUARINI. It was given a 6-month period so there would not be in and out trading on almost a daily basis, but there would be some thoughtfulness as to investments and some stability to the investments by letting the money stay in capital formation where it could probably do some good, and that instant trading would not bring any stability to the marketplace.

Now whether it is 6 months or 1 year, they are both arbitrary figures. It really comes down to what our revenue gains or losses are, and I am inclined to agree with Mr. Anthony that the behavioral pattern will be established later and it is something that we have already proven for decades that we can live with and live with very well.

Now one of the ways to raise revenue is to improve compliance. Now as I understand it, only 56 percent of capital gains taxes are actually collected, that there are 44 percent, from one report that I saw from the IRS, not collected.

Now we can tighten up on compliance and even bring money into our Treasury. This is probably the greatest gap we have in compliance of any of the laws that I know. Now on real estate transactions I assume that there are many that are done, that people may have sold their home and may not have been entitled under the circumstances to any kind of a capital gains tax exclusion but it never even appears on the report. I assume that there are many people throughout our country, through the recordkeeping process that we have, that get away with not reporting their capital gains.

In addition, the collectibles are probably the greatest violators that we have, and it is part of our underground economy. I think that we should tighten up. Now has any thought been given as to how we should do that?

Mr. CHAPOTON. Well, you are right. Our figures show the compliance rate in capital gains predates TEFRA, of course, is below 60 percent. We think that most of that, a lot of that—most of it, I would say—is not in the stock market but it is in real estate, collectibles, but there is some of it in stock as well.

In TEFRA you adopted provisions that did require reporting on securities transactions and we think that will help. We have the authority but have not extended that to real estate transactions and have not extended it to collectibles because of the problems that I mentioned earlier to Mr. Stark. But I would agree with you completely, Mr. Guarini. We should not give up our revenue in those areas because we know there is a lot of noncompliance.

Mr. GUARINI. I would imagine it is very easy to trace large transactions in banks where anybody making a transaction of more than $10,000 has to report it. Now if you were to have on, say, collectibles that it is a misdemeanor not to report to the IRS or make whatever kind of a criminal sanction you want to add to it, if a collectible is sold for over *x* thousands of dollars and a report is not made.

Because once a report is made you know the people are going to be very, very concerned and you are going to get, certainly, a certain percentage of compliance, where no compliance is done now. In real estate, there is no report made. Better records are kept in the stock market and for that reason we are collecting money.

But if, at the closing, it was the obligation of the buyer, the seller, whatever, to file with the IRS the fact that there was a transaction, that filing alone would be—it could be a very simple form—and it would give way to compliance which is absent from our country today.

Mr. CHAPOTON. That is true. In real estate, it would be easier, and I will repeat, we are looking at that very closely. In the collectables area, it is much more difficult. You could go to large transactions, and indeed the Senate Finance Committee on Monday night adopted a provision that requires cash purchases of more than $10,000 be reported to the IRS.

But you have to recognize that if the purchaser is intent on evading the tax, he can give a false name and it might be difficult to follow. But we also have to recognize that a lot of the avoidance is in small transactions, and that is the difficult part.

Mr. GUARINI. However, if there was an attempt or an effort made to have some criteria that people have to live by, so that if there was a violation, they would know that they would face a criminal sanction.

There would be many people that are buying jewels even on Park Avenue today that would not be putting cash down. They would be dealing a little bit more carefully and they would realize that there are rules of the IRS that they have to comply with or else there will be criminal sanctions. I think that will cull out at least a certain amount of noncompliance. It certainly will never cure all of it.

Mr. CHAPOTON. Clearly, reporting is the answer and making it work, though, as you know, is not easy and we get an awful lot of complaints when we extend the reporting rules.

Mr. GUARINI. If I may, Mr. Chairman, just have one more question, when you suggested that we should clean up the law with regard to stock options and straddles and reporting, et cetera—will that not bring a certain amount of moneys into the Treasury that would make up for whatever the early projected losses are?

Mr. CHAPOTON. We do not have a revenue estimate on those changes, but it is quite possible because we are seeking to avoid—to prevent some avoidance transactions.

Mr. GUARINI. Might not one thing help offset the other?

Mr. CHAPOTON. It could, yes.

Mr. GUARINI. Thank you.

Mr. PICKLE. Mr. Duncan.

Mr. DUNCAN. No questions, Mr. Chairman.

Mr. PICKLE. Mr. Downey.

Mr. DOWNEY. Thank you, Mr. Chairman.

Buck, have you see none of the committee reports where they talk about the Canadians' change? I think they call it ISIP, the proposal to tax the gain on capital investment in stock transactions.

Mr. CHAPOTON. On a mark-to-market basis?

Mr. DOWNEY. I think the way I saw it work is that they do a consumer price increase on the gain of 25 percent, of that gain would be taxed at the end of the year, would be exempt from inflation and it would also deal with the losses that would be incurred on a dollar-for-dollar basis.

Are you familiar with that?

Mr. CHAPOTON. I believe you are right. I believe it has indexing and a mark-to-market system. But no, we really have not studied that.

Mr. DOWNEY. Well, let me deal with one quick unrelated question that has to do with the work that the Ways and Means Committee has been doing and hearings that have been held on the fact that there are taxpayers who live below the poverty line who are paying taxes.

Can you tell us if Treasury has any proposals to deal with this problem and whether or not we will be looking at some way possibly to change to either an income credit or a standard deduction so that people who live at or below the poverty line are not forced to bear the burden of taxation?

Mr. CHAPOTON. We are, Mr. Downey, looking at that very point. The suggestion that—basically through the personal exemption and the zero bracket amount, we have attempted over the years, and have done a pretty good job, to keep the nontaxable level right at the poverty line, and it has to be adjusted every once in a while.

We are looking at that now. Of course, the change in the personal exemption would do it or in the zero bracket amount would probably be the way that you would look at it.

Mr. DOWNEY. But the Treasury recognizes that now there is a problem that in fact there are people who have slipped into the taxable category who are below the poverty line?

Mr. CHAPOTON. I saw that report in the newspaper. I have asked for a report from my people. I believe it is accurate, but I have not gotten that yet.

Mr. DOWNEY. Would the Treasury be willing to look at, for instance—and I would like your critical comments on this—an effort in this committee and on the floor to deal with that problem by changing the tax liability of banks perhaps by a minimum tax, or do something of that nature to pay for this effort?

How would that be viewed?

Mr. CHAPOTON. As I said, in connection with the long-term capital gain holding period, I think we probably ought to avoid, even though we do it every time we get into this problem, given the deficit situation, we ought to avoid looking at a beneficial or correct change and try to make someone else pay for it. I think that is probably not a good way to go, even though I recognize as a practical matter that we are all going to look at it.

The problem you raise ought to be viewed independently of how you are going to pay for it.

Mr. DOWNEY. Thank you, Mr. Chairman.

Mr. PICKLE. Mr. Matsui.

Mr. MATSUI. I will pass, Mr. Chairman.

Mr. PICKLE. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. Chapoton, once again on this committee we are talking about stimulus behavior. I often think that this gets us far away from the principal function of our revenue code. It is to raise revenue. Our tax code is to raise revenue for the functions of Government, yet we have lawyers and accountants talking about behavior and stimulus. Perhaps we ought to have psychiatrists and psychologists advising us if that is the direction we are going to continue to move in the years ahead.

I do not think there is anything magic about 12 months or 6 months. I do not have any strong feelings about it. There is certainly nothing magic about the 12-month period.

There is something that I think is a little special about the Federal deficit, however. We have a $196 billion deficit at the moment. The proposal before us indicates a loss of revenue of about $600 million in a 3-year period, and I guess the question is: Are there compelling reasons that we ought to do that, to add to the most significant deficit this country has ever seen by changing the tax code in this way?

Mr. CHAPOTON. Mr. Dorgan, our numbers—and we do need for the benefit of the committee to reconcile the differences between the joint committee and our numbers, but our numbers show a loss below $200 million over the 3-year period.

I think your point is well made. We think it is a desirable change in the law. It does have a small impact on the deficit, a very small impact on the deficit. We think it improves the efficiency of the marketplace and that it does—and I come back to your first comment—it is not an incentive device. We recognize that any tax on savings is a disincentive to savings, so we already have a disincentive.

When you reduce the tax on savings, you remove that disincentive to some extent.

Mr. DORGAN. I do not understand why this enhances the marketplace. It seems to me that the question of whether one ought to invest in the steel mill and silicon valley or an apartment building ought to be left to the marketplace. I do not think that the creation of capital gains preference in total really moves in and intercepts part of the marketplace decision.

Don't you agree?

Mr. CHAPOTON. You mean a preferential rate for capital gains in general?

Mr. DORGAN. Right.

Mr. CHAPOTON. The best thing we could have in the tax system is a neutral tax system—that is, be neutral across investment. We have all said that. I said it a lot of times, and I think most of the Members here probably would agree with that point.

In capital appreciation, though, where we do not tax it currently and it is subject to—we do not index it, you have special problems. We have had a preference for capital gain in our law basically since the history of the income tax, and I think that it by and large probably serves a good function.

Mr. DORGAN. Well, the key, I think, is the word "probably" that you use.

Mr. CHAPOTON. I concede that one can not unqualifiedly say what the impact of it is, and indeed we are studying that very point now. But we recognize that when you look at the figures in the late 1970's, a large part of capital gains that were taxed were not gains at all but inflation.

Mr DORGAN. I share an interest of those who have testified to make sure that a money pool is available for investment capital, for venture capital, risk capital. But, by the same token, you will admit, I am sure, that the benefit in capital gains goes to far more than just those who are contributing to venture capital or risk capital.

Now the money that we would lose and ostensibly would increase the Federal deficit, 72 percent of the money would be kept by people with $50,000 or more in income. That is where the tax benefit would go under this approach.

The question I have is, what are you doing with that? What are you creating with that kind of revenue loss? Is this, as I have seen in many instances, is this an economic merry-go-round where you ride a lot but you really do not go anywhere? Is it really an economic creation that produces jobs and so on?

Or is this once again providing tax benefits to some very wealthy people in this country who at this point do not need them because they benefited from the largess of the first 3 years and in exchange for which they would trade assets back and forth, trade 48-unit apartment buildings back and forth, and create this paper entrepreneurialism that saps our economic strength and really does not create anything for the country?

Mr. CHAPOTON. If you look at an individual trade, you are not creating anything. The thing you are doing is making the marketplace more attractive and, therefore, making it easier for new companies, for existing companies to raise new money. So if you look at the individual trade, I agree with you, but I think that is not the proper way to analyze it.

Mr. DORGAN. But there is a lot of that that goes on, you will admit.

Mr. CHAPOTON. But that is what makes the market able to raise money, new money, because a person can get out and that is why they are willing to get in.

Mr. DORGAN. My concern is that this is just the same bowl of soup with a little different seasoning that we have been hearing about for the last few years, that if you cut taxes somehow you will be all right. In fact, we will probably increase taxes in the long run.

I think there are reasons at times to provide preferences, selectively, and to determine what kind of conditions we want to create for this and that. And certainly the creation of venture capital and risk capital is a high priority for me and the rest of this committee.

The question is whether reducing the holding period to 6 months is going to accomplish that or whether it will simply butter the bread of those who have been furnished so much bread already.

Mr. PICKLE. Mr. Pease.

Mr. PEASE. Thank you, Mr. Chairman.

Mr. Secretary, I want to look at the deficit issue also for a minute. Is it still the position of the Secretary of the Treasury that deficits have no significant impact on interest rates?

Mr. CHAPOTON. I think the Secretary's point on that, Mr. Pease, has been made again and again, and in some quarters I think it has been misinterpreted, that he cannot find a direct relationship, that there are a number of factors that affect interest rates and that when you look over the history and relate interest rates to the deficit there does not seem to be a direct correlation.

Now, as we all know, there are a lot of other factors intervening in each of those years, so the analysis may be not wholly instructive.

Mr. PEASE. Is that a factor in your decision, Treasury's decision, to support this shortening of the capital gains holding period at this time?

Mr. CHAPOTON. It is not a factor to any extent, no, sir.

Mr. PEASE. Do I take it from your testimony in favor of this change at this time that the Treasury does not object to statutory changes which increase the deficit as long as the cause is noble and the loss does not exceed a few hundred million dollars?

Mr. CHAPOTON. Well, I think I could agree with that statement in general, yes, sir, depending on how noble the cause is. I think in this committee, as we did when the suggestion was made by Mr. Moore that we allow no deductible contributions to individual retirements accounts, we analyzed the provision on its merits and we hope that if it is beneficial it does not have a significant revenue impact. I think that is where we come out here.

Mr. PEASE. How about something that our Public Assistance Subcommittee talked about yesterday—shelters for battered women? That would only be $50 million at the most. Would the Treasury support that since it is a minimal loss in revenue?

Mr. CHAPOTON. Mr. Pease, that is a little outside of my jurisdiction and, happily, outside of Treasury's jurisdiction as well.

Mr. PEASE. I am just trying to find out how consistent the administration's policy is.

Do you assume that there would be increased activity from this shortened holding period?

Mr. CHAPOTON. Yes.

Mr. PEASE. Do you assume that the traders would make more money as a result? Have you factored in an increase in——

Mr. CHAPOTON. I think the traders probably think they will make more money. I do not think that that would be a significant factor to any extent in our revenue estimates.

Mr. PEASE. I see.

Mr. Guarini, I would think, would be especially sympathetic to a request to ask one more question of the witness.

Mr. GUARINI [presiding]. Certainly. I just want to remind everyone that there are five panels and I appreciate the pointed questions that are being asked, and certainly you may continue within your limit.

Mr. PEASE. Thank you, Mr. Chairman.

I would ask, finally, about this distinction between productive and nonproductive assets or investments. I do not have any trouble at all with encouraging people in every way we can to invest in new stock, new companies, or new stock issues of existing companies, but I guess I wonder what social purpose is served by exchanging stock among existing companies.

Can you see any way at all to fashion a policy which would encourage investment in new issues and new companies without necessarily affecting others?

Mr. CHAPOTON. No. On the contrary, lots of proposals have been made dealing with new issues of stock and trying to give preferential treatment, and indeed we have a small provision in the law that gives ordinary loss on new issues of stock up to a limited dollar amount.

But I think those type of changes are not the desirable changes because while you think of these transactions as simply trading from one shareholder to a new shareholder, as I pointed out earlier, the effect is that it makes the market more viable and the viability of the market is it allows companies, it permits companies, new companies and old companies to raise new capital.

And that is, it seems to me, what this is all about. The new capital is hopefully new savings. To some extent it is new savings, to some extent it is transferred savings, but that is a desirable effect—a viable market and the ability to raise capital and some impetus to new savings.

Mr. PEASE. Thank you.

Mr. GUARINI. Thank you.

Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman.

Buck, I wanted to make sure I understand. Mr. Pease asked whether there would be more or increased activity if we reduce the holding period and you indicated yes, there would be. It is my understanding, then, that you are saying that there would also be an increase in investment as a result of reduction of the holding period, or is it more that the value of the stock will go up because of the activity in the market and, therefore, that gives the companies more of an ability to raise capital?

Mr. CHAPOTON. I am not commenting on the value of the market in general going up. I am commenting on the fact that it reduces, because it has a small revenue loss in our estimate, it reduces slightly the tax on capital, on this form of savings.

In addition, there will be an increase in transactions, but that is not the—well, that is a factor. It does make the marketplace more viable. But from a revenue standpoint I think that is not the key.

Mr. MATSUI. In your opinion—I can understand reducing the rate down to 28 or even below resulting in the behavior of the investor to change. That is, well, I think I will put some of my money in these areas rather than in some other areas. And that makes sense.

And, of course, the arguments being made for reducing the holding period is that it will increase investment—at least I am assuming that is the purpose of it—not just to give people, brokers, an additional fee.

Are you saying that there will be an increase in investment in the market if we reduce the holding period from 1 year to 6 months?

Mr. CHAPOTON. Yes; but we are saying that because of the slight decrease in tax. You are right. I think your analysis is correct. You analyze the reduction in the rate quite differently than this. The reduction in the rate is easy to see. People are going to go into that market because the tax wedge, the tax penalty on gain is decreased.

This is a different analysis, but there would be a small decrease in the tax in our analysis as a result of the change.

Mr. MATSUI. But you are not saying that as a result of that it will create the kind of massive investment we saw in 1978 and beyond because the behavior of the investor will not be changed dramatically as a result of a reduction from 1 year to 6 months? Is that what you are saying?

Mr. CHAPOTON. That is correct. I would not expect that type of—but some increase in activity which does make the marketplace more viable apart from the revenue effect of that.

Mr. MATSUI. Right.

Now if we decrease the offset on the ordinary income from $3,000 to $1,000 will that have an appreciable effect upon the investor? Would that be a disincentive to actually invest money in the market?

Mr. CHAPOTON. Absolutely.

Mr. MATSUI. And that would be an appreciable disincentive?

Mr. CHAPOTON. It would be a disincentive, that is correct.

Mr. MATSUI. And this could have an effect upon investment in the United States, in your opinion?

Mr. CHAPOTON. That is correct.

Mr. MATSUI. And so if we adopt proposals to reduce the holding period from 1 year to 6 months, which basically helps those that make $50,000 and above, and reduce from $3,000 to $1,000 the ordinary income offset, which hurts basically those who make $50,000 and below, we also hurt the market. Is this correct, or the investment opportunities in this country?

Mr. CHAPOTON. You raise the tax. The second change raises the tax on the investment by disallowing losses that are now allowed, and so you do. Yes, you do hurt the——

Mr. MATSUI. That is why you have come down in your analysis that we should only reduce the 12 months to 6 months and not deal at all with the $3,000 to $1,000 issue?

Mr. CHAPOTON. That is correct.

Mr. MATSUI. Now why even bother with the first part of your conclusion, however, when you say that it really does not do much in terms of helping investment in the country in terms of capital investment, capital formation, new money in the marketplace, so to speak.

Mr. CHAPOTON. I am sorry, I did not get your question.

Mr. MATSUI. Why would you even support reducing the holding period if it doesn't really have an effect upon behavior except perhaps give some people a slight tax break?

Mr. CHAPOTON. No. It has an effect on behavior.

Mr. MATSUI. But you were saying that it was not really significant.

Mr. CHAPOTON. It would be a small increase in tax and it will be a small efficiency increase.

Mr. MATSUI. Why bother to do it?

Mr. CHAPOTON. We are supporting the change. We did not propose the change. It does seem to enjoy wide support and we think it is a good change.

Mr. MATSUI. At the same time, I think the question Mr. Pease asked and also Mr. Guarini and a number of other members, Mr. Dorgan, about the deficit issue. You had the tuition tax credit, the enterprise zone, and now the capital gains treatment issue. That probably adds up to about $1 billion a year in lost revenues, at least in the immediate future.

How do you reconcile that with our desire to lessen the fiscal deficit issue and now your giveaway in these three areas?

Mr. CHAPOTON. You raise a very good question, Mr. Matsui. If you look at the other proposals which are proposals that the administration has made, we also made a proposal that would offset that to some extent—the health care cap. But you are right; you have to analyze whether you are willing to take the revenue loss, which is more significant than the other proposals, the tuition tax credit.

Mr. MATSUI. I guess what you are saying is you are supporting this, but your support is somewhat lukewarm?

Mr. CHAPOTON. We are saying we are supporting it. We did not propose it. We think it would be a good change.

Mr. MATSUI. Thank you.

Mr. GUARINI. Thank you very, very much for your fine presentation, Mr. Chapoton.

Mr. CHAPOTON. Thank you, Mr. Chairman.

Mr. GUARINI. I would like to call the Security Industry Association, Mr. George L. Ball, vice chairman, board of directors, and chairman of the Tax Policy Committee, who is also president and chief executive officer of Prudential-Bache Securities. He is accompanied by Edward O'Brien, president, and Bernard Aidinoff, counsel.

Also on the panel, American Business Conference, Inc., John M. Albertine, president; and the American Council for Capital Formation, which is headed by Mark A. Bloomfield, the executive director.

Gentlemen, would you please come forward? We welcome you and we appreciate the benefit of your testimony and your advice and counsel on a very interesting proposal that is before us at this time.

I ask Mr. George L. Ball, president of Prudential-Bache Securities, to begin the presentation, if you will. Mr. Ball.

STATEMENT OF GEORGE L. BALL, VICE CHAIRMAN, BOARD OF DIRECTORS, AND CHAIRMAN, TAX POLICY COMMITTEE, SECURITIES INDUSTRY ASSOCIATION, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, PRUDENTIAL-BACHE SECURITIES, ACCOMPANIED BY EDWARD I. O'BRIEN, PRESIDENT, SIA, AND BERNARD AIDINOFF, COUNSEL

Mr. BALL. Mr. Chairman and members of the committee, we thank you for holding these hearings. We do appreciate the opportunity to explain once again the reasons why we support a shorter capital gains holding period, and we do think, too, that there are a couple of new wrinkles in the relevant knowledge base which certainly deserve your attention.

Most basically, though, the reduced holding period is probably a superb bit of public policy which will boost, we think, capital formation and mobility. It should help all of America. Investors indeed do understand that because it reflects cycle compression.

The 1-year holding period is out of sync with the volatility of today's financial world; 32 million stockholders really do not need to examine charts to appreciate that. They have invested in equities which have appreciated, only to watch those gains erode or disappear while they waited for a year's time to elapse. What once influenced stock or bond prices over 18 months seems now to occur in a fortnight.

When some of those stockholders step away from the equity markets, primary or secondary, everyone loses. American industry loses capital, expansion cannot be financed, jobs are not created, and tax revenues are lost. This is quite well understood by other industrialized nations. Their taxes on capital appreciation are much lower than in the United States.

Indeed, most of them have no holding period at all for capital gains; only Sweden has a longer one than we do. Several nations simply do not tax capital gains in any way. Most of these nations enjoy substantially greater rates of savings and investment than the United States.

In our own country investors have demonstrated great sensitivity to changes in tax policy. Twenty percent of them by number count left the stock market following tax increases in 1969, but returned after rate reductions in 1978. Their response to the expansion of individual retirement accounts exceeded all expectations by far. Individuals are instinctively probability-weighted, after tax bottom line focused.

It is no surprise, then, that investors told Opinion Research Corp. that a reduction in the capital gains holding period was a vital change that would induce them to increase equity investment by over $50 billion.

As important as a reduced holding period is to investors, it would hardly change Federal tax receipts. SIA believes that a shorter holding period would increase revenues by about $100 million per year, a very modest gain. Some others feel that it would reduce tax receipts.

However, all estimates agree that lowering the loss offset and truncating the holding period in combination would raise revenues by $1 to $2 billion over the next 5 years, depending on the commentator. It would bring in bucks in everyone's estimation.

How would investors view a shorter holding period combined with a lower loss offset limit? My firm asked its own clients that question a month or two ago. Eighty percent of them said that they would prefer a 6-month holding period, even if it means a reduction in the offset to $1,000. They do not buy stocks as a tax deduction; they invest for gain.

A reduced capital gains holding period has broad bipartisan support in both Houses of Congress. Many of the members of this very committee have cosponsored bills to make that change. The prior concerns about that change were understandably rooted in the possible reduction in Federal revenues.

Combined with a lower loss offset, the impact would clearly be revenue progenitive. Those still opposed have largely said that the shorter holding period would help the wealthy while the offset decrease would hurt the less affluent. To begin with, those helped or hurt are not indigent. They are Americans with at least some ability to save and invest. They need not be protected against themselves.

Next, they are not foolish. They invest for profit, not to be sheltered from loss. Four out of five of them—admittedly, in a large sample like ours we did not poll by income—but probably in a firm our size representatives of the investing populace overall wanted the combination rather than today's law.

Thus, if the Government wins and intelligent rationale investors prefer a change which affects them and the macroeconomic impact of that change is agreed by all to be positive, then action is warranted. That move would benefit the securities industry, but most of all it would benefit investment, capital formation, job creation and economic growth, and the Federal coffers.

We do urge its enactment. Thank you.

[The prepared statement follows:]

STATEMENT OF GEORGE L. BALL ON BEHALF OF THE SECURITIES INDUSTRY ASSOCIATION

SUMMARY OF COMMENTS

1. SIA supports a reduction of the capital gains holding period, and believes that it would increase investment, capital formation and Federal tax revenues.

2. For two decades, the growth of the Nation's physical plant has been inadequate to increase, or even maintain productivity, or to prevent the loss of millions of jobs. Reduced savings and investment rates contributed to the decline.

3. Other industrialized nations have experienced greater economic growth and capital formation than the U.S. Savings rates in those nations are higher then in this country, and their taxes on investment income are lower. Most industrialized nations have no capital gains holding period; many do not tax capital gains at all.

4. The 1978 legislation reducing capital gains tax rates produced dramatic results. Investors returned to the equity markets, financing for both emerging and established companies soared, and Federal revenues from capital gains taxes increased.

5. Opinion Research Corporation found that investors would respond to a reduction in the holding period by increasing their equity investment $50 billion or more. Investors' sensitivily to tax policy was demonstrated by their departure from the

markets after tax increases in 1969, their return after the 1978 tax cuts and their response to expansion of individual retirement accounts.

6. A reduction of the capital gains holding period would increase revenue by $100 million per year if increased investment and capital gains realizations parallel those prompted by the 1978 tax legislation. Other estimates project a reduction of revenues. All estimates agree that reversing the two changes in tax law tied together in 1976—restoring a 6 month holding period and reducing the loss offset against ordinary income—would increase revenues, ranging from $1 to $2 billion over the next 5 years.

INTRODUCTION

Mr. Chairman and members of the committee, I am George L. Ball, President and Chief Executive Officer of Prudential-Bache Securities. I currently serve as Vice-Chairman of the Board of Directors of the Securities Industry Association and Chairman of SIA's tax policy committee. Accompanying me today are SIA President Edward I. O'Brien and Bernard Aidinoff of the law firm of Sullivan & Cromwell. We thank the committee for holding these hearings and appreciate the opportunity to participate in them. The hearings provide a forum for detailed examination of the capital gains holding period which the committee did not have prior to either its 1975 decision to lengthen the holding period or in evaluating proposed legislation during the past two years restoring the six-month holding period.

SIA is the trade association representing over 500 securities firms headquartered throughout the United States and Canada. Its members include securities organizations of virtually all types—investment banks, brokers, dealers, and mutual fund companies as well as specialists and other firms functioning on the floor of exchanges. SIA members are active in all exchange markets, in the over-the-counter market and in all phases of corporate and public finance. Collectively, they provide the over 32 million investors with a full spectrum of securities and investment services and account for approximately 90 percent of the securities business done in North America.

Our purpose in presenting this testimony to the committee is twofold. First, to recommend that the committee act favorably on a proposal to reduce the holding period for long-term capital gains to six months; and second, to provide the committee with supporting evidence in evaluating the proposal to shorten the holding period. This supporting evidence is based on historical evidence resulting from actions taken by the Congress in 1978 and comparison with the tax treatment in other countries.

U.S. productivity has been declining consistently over the past two decades. Major factors affecting productivity are new and continued investment in equipment and the development of new manufacturing and technological processes. In order to increase productivity or, at the least, keep productivity from declining, the nation's stock of capital, both physical and human, must keep pace with the growth of the labor force. The capital markets provide the wherewithal for the development of our nation's capital stock. Just as Congress saw fit to lower capital gains tax rates in 1978 and rates on investment income at the beginning of 1982, a reduction in the holding period would continue the trend towards relieving tax benefits on investment.

According to Federal Reserve Board data, the annual growth rate in output per hour declined from about 3 percent before 1967 to 2 percent in the early 1970s and continued to decline since then. Only recently has the decline in productivity been halted with the economic recovery in 1983. However, this recent increase in productivity is a cyclical rather than a secular phenomenon. The decline in productivity is an underlying source of the persistent inflation experienced over the past twenty years.

Additional jobs have been increasingly difficult to create. In the 1970's alone, over 2 million industrial jobs were lost. There is a close casual relationship between productivity, jobs, and our capital stock (physical plant and equipment). The nation's capital stock has not grown at rates necessary either to maintain productivity at high rates or to increase productivity. The average annual growth of the capital stock in constant dollars has declined from 5 percent in 1965 to under 3 percent in 1977. Rates of saving and investment for the U.S. over the past decade contributed to the decline in the growth of capital. During the 1970's, personal savings as a proportion of disposable income has declined almost steadily to less than 5 percent.

There is a strong relationship between the growth of capital and macroeconomic growth. The U.S., when compared to other industrialized nations, ranks very low in rates of economic growth and, not at all surprisingly, in rates of capital formation.

Countries with the highest saving/investment rates (capital formation) have the lowest tax burden on investment income, and those with the lowest saving/investment rates have the highest tax burden on investment income. The policy implications are clear—economic growth can be stimulated by greater savings and investment (capital formation) through reducing tax rates in investment income.

IMPACT OF CAPITAL GAINS TAX CHANGE IN 1978

In our own country, we have a recent experience of how tax reductions on investment income stimulated capital formation in the U.S. The Revenue Act of 1978, through an increase in the capital gains exclusion from 50 percent to 60 percent and other changes, cut the maximum capital gains tax rate from 49 percent to 28 percent. In enacting the legislation, Congress believed that the high tax rates on capital gains contributed to a shortage of funds for capital formation—especially for new and smaller business—with the result that rates of economic growth declined and the competitive position of the U.S. deteriorated. The following data support the effectiveness and efficiency of the 1978 tax cut in stimulating capital formation.

Stock price indices

In 1979 and 1980, the economic environment was marked by record high and volatile interest rates and deterioration in the financial position of many corporations. Yet, substantial gains were recorded by the stock market indices, particularly those representing the smaller capitalized companies favored by individual investors. In the market decline of 1981, both the AMEX and NASDAQ indices fell less than the major indices. Since the revival of individual investor interest in stocks, all market indices have performed impressively, with the indices representing the smaller capitalized companies outpacing the major indices. Since end-December 1978 through June 1983, the AMEX and NASDAQ indices increased by a hefty 222 percent and 170 percent, respectively, and the S&P 500 and the NYSE indices each climbed by over 70 percent. The performance of these indices are critical because as the market value of these companies rises, their ability to raise capital inceases, enabling them to expand, thereby creating jobs and developing technological advances.

Initial public offerings

New and emerging companies have created the largest number of new jobs. Over 2.7 million jobs were created between 1979 and 1981, with 60 percent of the increase in total employment contributed by small businesses with under 500 employees.[1] The increased market value placed on the stocks of smaller companies produced a market climate conducive to the initial public offerings (IPOs) of new and emerging companies. In other words, the public was willing to provide equity capital for expansion and investment by emerging companies.

The effect of the 1978 capital gains tax reductions on capital formation was consistent with the experience of the immediately prior period. From 1969 to 1975, following increased capital gains taxes, the number of issues and the amount of dollars raised plunged 99 percent, from 548 issues which raised $1,457.7 million to 4 issues which raised $16.2 million. In the first half of 1978, only 16 companies went public, raising a meager $64.2 million. When passage of the Revenue Act was imminent in the second half of 1978, 29 companies came to market raising three times the capital obtained during the first half. From 1979 to 1981, the number of companies going public increased impressively but the amount of money raised soared even more. In 1981, a record-setting $3.2 billion was raised. Given depressed market conditions during 1981, the performance of initial public offerings (IPOs) was even more impressive.

With the value of new offerings in the first half of this year at $5.5 billion (includes IPOs of thrift institutions), 1983 already has far surpassed 1981's record for funds raised by IPOs. Excluding the conversions of mutual thrift institutions, 296 other issues came to market in the first half of 1983, for a share value of $4.6 billion. The market pickup that began in August of 1982 set the stage for a brisk IPO market in 1983. According to Going Public, June saw more money raised in IPOs than any other month since the 1950s. At the end of July, there were over 200 IPO issuers registered in anticipation of selling shares to the public, and as of October 20, 1983 there were 377 IPO issuers in registration, suggesting that the IPO market is still expanding. Capital gains taxes are not the sole reason for the very active IPO market thus far in 1983, but they definitely play a major role.

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[1] "The State of Small Business: A Report of the President," U.S. Small Business Administration, March 1983.

Venture capital

Venture capital is important in financing the development of companies in rapidly growing industries. Following the 1969 capital gains tax increase, new funds raised by venture capital firms averaged only $58 million in the 1970–77 period, reaching a peak of $97 million in 1970 and a low of $10 million in 1975. However, in 1978, venture capital firms raised a striking $570 million. After dipping to $319 million in 1979, venture capital raised leaped from $900 million in 1980 to an estimated $1.7 billion in 1982. Similarly, funds from venture capital firms to new businesses increased from $250 million in 1975 to almost $1.8 billion in 1982. Venture capital experts believe that the vigorous and sustained expansion of the venture capital industry resulted primarily from government actions that: (1) reduced the capital gains tax in 1978; (2) relaxed pension trust investment rules in 1979; and (3) further reduced the maximum tax on investment income from 70 percent to 50 percent in 1981.

The Revenue Act of 1978 led to higher stock prices, a more conducive market atmosphere for small companies and an increase in the supply of venture capital. In our professional opinion, investors would react to a reduction in the holding period similarly. SIA commissioned Opinion Research Corporation to undertake a survey of executives' reactions towards a change in the holding period. This survey was conducted in November 1981 and investors said they would respond to a six-month holding period by increasing investment, particularly in the common stock of new and seasoned companies. In surveys conducted by two national brokerage houses, their customers were enthusiastic about a reduced holding period and believed it would lead to additional investment and higher stock prices.

Basic to evaluating a change in the holding period is that a reduction of the holding period from one year to six months is equivalent to a reduction of the capital gains tax rate on capital gains realized in months seven to twelve. Thus, in our opinion, reducing the holding period will have similar desirable effects in promoting capital formation as did the 1978 capital gains tax rate cut. This will increase the ability of companies to raise capital and create new products and jobs.

INTERNATIONAL COMPARISON

As indicated earlier, significant differences between the U.S. economic growth rate and those of most industrialized nations are due in part to differences in the tax treatment of investment income. A study commissioned by SIA and undertaken by Arthur Andersen provides details which illustrate these differences. The full Arthur Andersen study is attached as Exhibit A.

Table I presents comparative data on the holding period and the maximum tax rates on capital gains for the United States and ten other industrialized countries. The table indicates that:

(1) Only one nation has a longer holding period than the U.S. Eight other countries have either a shorter holding period or none whatsoever. Only one other country—Australia—has a one-year holding period, but it exempts long-term capital gains from taxation. Only Sweden has a holding period exceeding one year.

(2) The U.S. maximum tax on long-term capital gains is the third highest of the eleven countries. Six of the other ten do not tax long-term capital gains at all. Two additional countries tax long-term capital gains at rates lower than the U.S. (Canada at 17 percent and France at 15 percent). Only Sweden (22 percent) and the U.K. (30 percent) have higher maximum tax rates.

(3) Concerning short-term capital gians, the U.S. has the fourth highest tax rate. Only Australia, Germany, and Sweden have higher rates than the U.S. on short-term gains. Of the seven with lower rates, four have no tax on short-term gains.

TABLE I.—COMPARISON OF INDIVIDUAL TAXATION OF CAPITAL GAINS ON PORTFOLIO STOCK INVESTMENTS IN 11 COUNTRIES

Country	Percent		Minimum holding period to qualify for long-term gain treatment	Maximum annual net worth tax rate (percent)
	Maximum short-term capital gain tax rate [1]	Maximum long-term capital gain tax rate [1]		
United States	50	20	1 year	None.
Australia	60	Exempt	do	Do.
Belgium	Exempt	do	None	Do.
Canada	[2] 17	[2] 17	do	Do.
France [3]	15	15	do	Do.

TABLE I.—COMPARISON OF INDIVIDUAL TAXATION OF CAPITAL GAINS ON PORTFOLIO STOCK INVESTMENTS IN 11 COUNTRIES—Continued

Country	Percent		Minimum holding period to qualify for long-term gain treatment	Maximum annual net worth tax rate (percent)
	Maximum short-term capital gain tax rate [1]	Maximum long-term capital gain tax rate [1]		
Germany	56	Exempt	6 months	0.5.
Italy	Exempt	do	None	None.
Japan	do	do	do	Do.
Netherlands	do	do	do	0.8.
Sweden	54	22	2 years	3.
United Kingdom [4]	30	30	None	None.

[1] State, Provincial and local taxes not included.

[2] Provincial taxes in Canada approximate a 48 percent add on to Federal tax.

[3] Gains from proceeds of up to $20,445 (FF 150,000) are exempt from taxation in a given taxable year.

[4] The first $7,725 (£ 5,000) of gain is exempt annually.

Source: "Comparison of Individual Taxation of Long and Short Term Capital Gains on Portfolio Stock, Investments and Dividend and Interest Income in Eleven Countries," prepared for SIA by Arthur Andersen & Co., June 1983.

Several nations also have special incentives for equity investment. The United Kingdom exempts the first 5,000 pounds of capital gains annually. France exempts gains from the first 150,000 francs of sales proceeds each year. Canada has recently provided a basis adjustment for inflation and spreads the tax impact of gains or losses over four years if the taxpayer elects an account which is "marked to market." The major differences between the tax treatment of capital gains in the U.S. and in other industrialized nations are accounted for by the rate of taxation and the holding period.

These facts indicate that the U.S. tax treatment of investment income is not comparable to other countries in expanding the economy and employment market. Even with a reduction of the holding period to six months, the U.S. combined treatment of holding period and taxation of short-term and long-term capital gains would still be higher than in most industrialized nations. Nevertheless, a shorter holding period represents a substantial improvement over present treatment.

REVENUE IMPACT

Much of the recent debate has focused on the tax revenue impact of reducing the holding period from twelve to six months. Yet, all estimates of the tax revenue impact are minimal in either direction. They range from an estimate that reducing the holding period will raise an additional $100 million per year in the short run to a $200-$300 million loss per year. Even if a modest loss occurred, it would be insignificant compared to the clear need for additional capital formation or to total federal revenues.

Various government estimates conclude that reduction of the holding period to six months would result in a tax revenue loss ranging from $200-$300 million per year, depending on the year analyzed. In contrast, SIA/DRI estimate that a six-month holding period would have increased revenues by $200-$300 million from 1979-81. The basic difference between estimates is that SIA/DRI assumes a greater level of investment and realizations under a six-month holding period, whereas government estimates only assume a change in the timing of realizations, but no change in aggregate realizations over the years analyzed. In other words, we believe experience since the 1978 cut support our assumption that a shorter holding period will affect the behavior of investors and their actions will generate higher taxes. The NYSE estimates that complete elimination of the holding period would raise an additional $29 million to $250 million per year. Importantly, all of these estimates are in the neighborhood of a maximum tax revenue gain or loss of a few hundred million dollars per year.

The government estimates assume that investor behavior is fairly insensitive to changes in the capital gains tax rate or holding period. Estimates of a tax revenue loss for the 1978 tax cut were also based on this assumption. The increase in realizations and revenue gains following the 1978 tax cut indicate that investor behavior is very sensitive to tax cuts on investment income. Similarly, a reduction of the holding period to six months will generate additional tax revenues through greater investment and realizations.

The Council of Economic Advisers (CEA) concluded that the sharp rise in realizations meant that the Treasury collected more revenues because of the 1978 capital gains tax cut. CEA Chairman Martin Feldstein stated that the "experience of 1979 does provide a strong indication of a powerful effect of reducing the capital gains tax." [2]

The American Council for Capital Formation also believes that realizations went up sharply because of the capital gains tax cut in 1978. They noted the following: "It is clear that capital gains realizations are up sharply since the 1978 tax cut, no matter whose definitions are used." [3] (See Table II.)

In addition, the taxes actually paid on capital gains also rose dramatically. These taxes increased from $9.3 billion in 1978 to $11.2 billion in 1979 and to $11.9 billion in 1980. While preliminary figures show a 5 percent increase in 1981 realizations, taxes paid on these gains are estimated at $11.6 billion by the Treasury staff due to the 1981 tax cut.[4]

TABLE II.—SELECTED MEASURES OF CAPITAL GAINS REALIZATIONS

[In billions of dollars]

	Net long-term gain less short-term loss	Net long-term gain less short-term loss plus short-term gain	Net long-term gain less net long-term loss
1977	43.9	45.9	30.3
1978	48.6	50.5	37.7
1979	70.5	73.4	63.8
1980	69.9	74.6	65.3

SIA and Data Resources Inc. (DRI) estimate that, if rates had remained unchanged in 1978, tax revenues would have been reduced by $2.3 billion for 1979 and 1980. These estimates coincide with work conducted by a Treasury consultant who, using a time series model, estimated that without the 1978 tax cut, realized capital gains would have increased by only 11 percent in 1979 and then declined slightly in 1980.[5] in other words, the effect of the first two years of the tax cut was to increase realizations by an average of about 33 percent over what otherwise would have taken place, with tax revenues spurting by about $0.9 billion in 1979 and $1.6 billion in 1980.

Government staff estimates of the impact of the capital gains tax reduction in 1978 were way off the mark because they did not provide for increased investment in capital. Thus, early government estimates on the 1978 revenue impact of reduced taxes on capital gains predicted losses, whereas the actual results showed substantial gains.

For similar reasons, government estimates were wrong in projecting the funds that would flow to IRAs and consequently the tax loss resulting from the liberalization of IRA contributions. In an August 1983 report, the Life Insurance Marketing and Research Association, Inc. (LIMRA) estimated that $40 billion was invested in individual retirement accounts in 1982, resulting in lost tax revenue of $11.2 billion. The $40 billion is more than four times the $9 billion originally projected by the Treasury Department and more than double the Department's revised estimate of $19 billion.

LIMRA's estimates were based on an April 1983 survey of nearly 3,800 households. Among other things, the survey asked how much of the money invested in IRAs was "new" or out of current earnings, why or why not respondents opened IRAs, where IRAs were opened, and data about the respondents.

Four out of five 1982 IRA holders contributed some current earnings or "new money," the survey found. The total new money invested in IRAs in 1982 was 53 percent. Sixty percent of IRA holders said they would have saved this money even without their IRA, but 29 percent said they would have saved only a portion of their funds invested in IRAs, and 11 percent would have spent all of it. this survey indicates that individuals will respond positively to changes in tax rates on capital. Both the experience since the 1978 capital gains tax cut and the LIMRA survey strongly support assumptions that individuals respond positively when the after-tax return on capital increased and that "static" assumptions are inappropriate.

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[2] "Tax Rules and Capital Gains," Remarks of Martin Feldstein to the National Venture Capital Association, Apr. 21, 1983.

[3] "Letters to the Editor," Tax Notes, May 23, 1983.

[4] To prevent adverse effects on the marketplace caused by taxpayers postponing transactions until the 20 percent maximum rate became effective in 1982, a special rule was devised to prevent suspension of sales during the second half of 1981. Under this rule, the maximum 20 percent capital gains rate was effective after June 9, 1981.

[5] Gerald E. Auten, The Taxation of Capital Gains: An Evaluation of the 1978 and 1981 Tax Cut for Capital Gains, Bowling Green State University.

Both the 1978 capital gains rate reductions and the 1981 expansion of Individual Retirement Accounts produced dramatic responses from investors and savers which were not anticipated by government revenue estimates. As a result, the capital gains reductions actually led to higher, rather than lower federal revenues, while the IRA expansion cost the government even more than anticipated. The special role of your committee is to sort out these different assumptions and facts. In our judgment, the data support assumptions that investors are responsive to tax changes on their investments.

SIA and DRI developed a methodology for measuring the willingness of individuals to realize gains when capital gains taxes or the holding period are changed. The change in realizations to lower tax rates was used as a standard to evaluate the impact of a reduce holding period. The increase in realizations since the reduction in the maximum tax rate on capital gains in 1978 suggests substantial "unlocking." Once the relationship between realizations and changes in capital gains tax rates since 1978 were measured, we estimated the impact of a reduced holding period. If the holding period were six rather than twelve months, gains realized in months 7-12 would become long-term gains and it was assumed that investors would respond on assets held for 7-12 months like they did with the lowering of rates on gains held for longer than one year. In other words, if realizations increased by 50 percent since the tax cut in 1978, it was assumed that if the holding period had been six months, gains realized in months 7-12 also would increase by 50 percent because they would also qualify as long term. A detailed explanation of our methodology is provided in Appendix B

We conclude that, based on realistic and conservative assumptions, the government would have raised at least $200-$300 million in additional revenues if a six-month holding period were in effect for 1978 to 1981.

TAX REVENUE IMPACT OF 6-MONTH HOLDING PERIOD AND CAPITAL LOSS REDUCTION TO $1,000

The holding period was lengthened to one year in an attempt to recoup revenue losses expected to result from increasing the capital loss offset against ordinary income from $1,000 to $3,000. The two changes were phased-in together from 1976-78, and the net revenue impact was estimated to be $191 million over five years. Instead, according to recently released Treasury data, the two proposals reduced federal revenues by about $300 million per year.

Even if our estimates of the revenue impact of a six-month holding period are wrong and government estimates are correct, all estimates agree that a reduced holding period, coupled with a reduction in the loss offset from $3,000 to $1,000, would generate additional revenue for the government. Each measure changes the tax treatment of capital losses. First, reducing the holding period to six months would convert some short-term capital losses into long-term capital losses, only 50 percent of which are deductible against ordinary income. Second, reducing the capital loss deduction from $3,000 to 1,000 against ordinary income would raise government revenues. Treasury and the Joint Committee on Taxation estimate that reducing the capital loss deduction from $3,000 to $1,000 by itself would raise $500-$600 million per year in tax revenue, which would more than offset their estimates of a loss due to reducing the holding period to six months. According to these groups, the net result of combining the two proposals would be additional tax revenues. Thus, any arguments opposing a change in the holding period on grounds of its revenue impact disappear completely if the reduction in the loss offset to $1,000 is implemented.

WHO REALIZES GAINS?

Opponents of a shorter holding period argue that such a change benefits only the "rich." If a reduced holding period generates additional tax revenues, more money is extracted from those realizing gains, not less. Moreover, the economy will grow if people with savings invest in financial instruments that are used to build new plants and buy new equipment rather than in tax avoidance schemes.[6]

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[6] Editorial Comment, "Soak the Rich?" Wall Street Journal, 2/12/81.

The data in Table III show that until 1979, capital gains were centered in the income brackets between $30,000 to $100,000, with the largest percentage received by the $30,000-$50,000 AGI group. About three-fourths of all gains were received by taxpayers with AGI under $100,000. Moreover, one-fourth was received by those with AGI under $20,000 per year.

As noted earlier and in Table III, realizations skyrocketed by about 45 percent in 1979 and 1980 over the 1978 level. Along with the spurt in realizations, there was a redistribution of capital gains by AGI class. The most dramatic change was in the relative share of realizations by individuals in the AGI class $200,000+. In general, while the share of realizations by this group increased in 1979 and 1980, that of individuals in the AGI classes under $50,000 fell. However, even the AGI classes under $50,000 experienced increases in realizations after the capital gains tax cut of 1978.[7]

Although all AGI classes reported increased realizations in 1979 and 1980, the most impressive increase took place in the AGI class $200,000+ which accounted for about 55 percent of the increase in realizations over 1978. Clearly, this income group was very responsive to the change in the 1978 tax law. Even with the decline in the maximum capital gains tax rate from 49 percent to 28 percent, the amount of revenue raised from this income class rose sharply in 1979 and 1980. We estimate that taxes from this income class rose from $3.8 billion to about $5.5 billion or almost 31 percent. In other words, by increasing the realizations of the highest income class, taxes paid by this group increased $1.7 billion despite a steep drop in the maximum tax rate on capital gains. In our opinion, the same pattern would develop if the holding period were reduced to six months.

TABLE III.—NET LONG-TERM CAPITAL GAIN IN EXCESS OF NET SHORT-TERM LOSS

[Dollars in billions]

AGI[1]	1977	Percent of total	1978	Percent of total	1979	Percent of total	1980	Percent of total
0 to $10	$5.8	13.2	$5.7	11.8	$6.9	9.8	$6.8	9.7
$10 to $20	6.3	14.4	6.8	14.0	7.0	10.0	7.2	10.3
$20 to $30	6.0	13.7	6.7	13.8	7.6	10.8	6.7	9.7
$30 to $50	7.4	16.8	8.6	17.7	11.0	15.6	9.4	13.4
$50 to $100	6.8	15.5	7.9	16.3	10.7	15.2	11.9	17.0
$100 to $200	4.2	9.6	5.2	10.7	7.6	10.8	8.2	11.7
$200+	7.4	16.8	7.6	15.7	19.5	27.7	19.7	28.2
Total	43.9	100.0	48.6	100.0	70.5	100.0	69.9	100.0

[1] In thousands of dollars.

Note.—Figures may not add to total due to rounding.

Source: Statistics of Income, IRS.

Additional data are available showing that a six-month holding period would benefit a broad spectrum of investors. Table IV includes data for various income groups showing the distribution of realizations by holding period in 1973 and 1977, when the holding period was six and nine months, respectively. For 1973, the distribution of realizations in months 7-12, is nearly equally divided between AGI classes below and above $50,000. More specifically, almost 48 percent of all gains realized in months 7-12 were for the under $50,000 group.

For 1977 (when the holding period was nine months), 45 percent of the realizations in months 10-12 were received by the AGI class under $50,000. In other words, if the holding period in 1973 and 1977 had been 12 months, the distribution of those long-term gains which would have been converted into short-term gains, was equally divided between AGI classes above and below $50,000. No later data are available on the distribution of gains by holding period. However, the limited available information indicates that the "rich" are not the only ones who would benefit from a reduced holding period. Indeed, the Statistics of Income series indicates that the largest slice of capital gains is realized by middle-class individuals.

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[7] AGI classifications in 1977 and 1978 preclude a detailed examination of gains realized by the $30,000 to $100,000 group in those years. However, given the more detailed AGI classes for 1979 and 1980, we estimate that the $60,000 and under AGI class realized about 50 percent of capital gains reported in those years.

TABLE IV.—CAPITAL GAINS REALIZED FOR SELECTED MONTHS BY AGI CLASSES

[Dollars in thousands]

Gains realized in months	AGI			Total
	$50,000+	$20-$50,000	0-$20,000	
1973—6 months holding period:				
6 to 7	$69,711	$26,269	$14,805	
7 to 8	42,864	15,730	72,482	
8 to 9	46,484	25,872	29,133	
9 to 10	47,002	35,600	8,572	
10 to 11	30,221	12,822	5,507	
11 to 12	48,382	14,375	5,133	
Total	284,664	130,668	135,632	$550,964
Total (percent)	51.6	23.8	24.6	100
1977—9 month holding period:				
9 to 10	$45,939	$25,349	$8,533	
10 to 11	73,669	31,489	17,857	
11 to 12	160,819	106,884	39,567	
Total	280,427	163,722	65,957	$510,106
Total (percent)	55.0	32.1	12.9	100

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, March 1982.

DOES A 6-MONTH HOLDING PERIOD ENCOURAGE "SPECULATION"

Another argument against the six-month holding period is that a shorter holding period encourages "speculation" rather than "investment."

"Investment" (capital formation) consists of corporate investment of funds in new and additional capital plant and equipment. The source of these funds is either internal—retained earnings—or external. Externally, funds can be raised in a number of ways: short-term loans, long-term loans (debt securities) or initial (IPO) or additional (primary) public equity offerings. External financing of capital formation transfers funds from economic units which have savings in excess of their investment needs to units whose investment needs are greater than their savings. The market in which either IPOs or additional securities are offered is the primary securities market. In this market, funds are transferred to economic units for investment (capital formation). The market in which securities are traded after the initial offering is the secondary market. No further funds are raised or lost for issuers whose securities are traded in the secondary market. Nevertheless, the secondary market contributes to the marketability of securities and the ability of investment bankers to raise additional capital for business.

There is absolutely no evidence that a shorter holding period steers investors away from the primary market—IPOs and primary issues—where capital is raised (productive investment). The relationship between holding period length and investor interest in either the primary or secondary market is that a longer holding period discourages investment in either, then "locks" investors into their investments and reduces funds available for IPOs and primary offerings. Since a longer holding period makes the secondary market less "liquid," the potential transfer of funds from the secondary market to the primary market is reduced.

A six-month holding period was in effect in the U.S. for almost 35 years—from 1942-1976—and benefited the capital raising abilities of corporations via primary market offerings. Furthermore, the capital raising abilities of corporations are not affected by how long initial investors (in IPOs or primary offerings) hold their securities. Once a corporation has sold its securities, it does not matter whether the investors who bought these securities held them for six months or five years. Their initial purchase transferred funds to corporations for capital investment and is not affected by when the sale of these securities occurs subsequently.

APPENDIX A

COMPARISON OF INDIVIDUAL TAXATION OF LONG- AND SHORT-TERM CAPITAL GAINS ON PORTFOLIO STOCK INVESTMENTS AND DIVIDEND AND INTEREST INCOME IN 11 COUNTRIES

INTRODUCTION

This report provides an overview of the taxation of gains realized on the sale of portfolio stock investments by individual residents of eleven major industrialized countries. Only the general taxation rules have been outlined. Consequently, certain specialized situations (such as the sale of stock of closely held companies or sales by individuals considered to hold inventory) are not covered in detail. In addition to the current tax status of such gains, a summary of changes which have occurred in the taxation of such gains during the past seven years has been included. Also included is a description of any wealth or net worth taxes which would apply to securities.

This report also contains an overview of the taxation of dividend and interest income received by individual residents of the eleven countries. Again, only the general rules have been presented. In addition to the current tax status of dividend and interest income, a summary of major changes which have occurred in the taxation of such income during the past seven years has been included where applicable.

The first section of this report summarizes the major differences in the treatment of capital gains and dividend and interest income of the eleven countries studied. The next two sections explain these differences in greater detail.

It is important to note that within the past two years, the major change in this comparison resulted from the reduction of the maximum marginal tax rate on investment income from 70% to 50% in the U.S. This brought the U.S. tax treatment closer to, but still relatively harsher than, that on capital gains in the other countries. The lack of corporate/shareholder tax integration in the U.S. also renders the U.S. tax treatment of distributed corporate profits as one of the harshest.

COMPARISON OF INDIVIDUAL TAXATION OF CAPITAL GAINS ON PORTFOLIO STOCK INVESTMENTS IN ELEVEN COUNTRIES

Country	Maximum Short-Term Capital Gain Tax Rate*	Maximum Long-Term Capital Gain Tax Rate*	Minimum Holding Period to Qualify for Long-Term Gain Treatment	Maximum Annual Net Worth Tax Rate
United States	50%	20%	One Year	None
Australia	60%	Exempt	One Year	None
Belgium	Exempt	Exempt	None	None
Canada	17%**	17%**	None	None
France(1)	15%	15%	None	None
Germany	56%	Exempt	Six Months	.5%
Italy	Exempt	Exempt	None	None
Japan	Exempt	Exempt	None	None
Netherlands	Exempt	Exempt	None	.8%
Sweden	54%	22%	Two Years	3%
United Kingdom(2)	30%	30%	None	None

* State, provincial and local taxes not included.

** Provincial taxes in Canada approximate a 48% add on to federal tax.

(1) Gains from proceeds of up to $20,445 (FF 150,000) are exempt from taxation in a given taxable year.

(2) The first $7,725 (£ 5,000) of gain is exempt annually.

COMPARISON OF INDIVIDUAL TAXATION OF LONG AND SHORT-TERM CAPITAL GAINS ON PORTFOLIO STOCK INVESTMENTS IN ELEVEN COUNTRIES

Of the eleven countries reviewed, only Canada includes in the taxable income of individuals a greater percentage of long-term gain than does the United States. But even in Canada, there is no holding period required for long-term capital gain treatment and the maximum federal tax on income is 34% as compared to 50% in the United States. Canadian provincial tax, however, approximates 48% of federal tax. Canada includes 50% of long-term gain, while 40% is included in the United States and Sweden. These countries tax the includable gain at ordinary income tax rates. The United Kingdom taxes gains at a flat 30% tax rate and France generally taxes gains at a flat rate of 15% and both countries also provide limited annual exemptions. The remaining six countries do not tax long-term gains at all.

In terms of the minimum holding period required to qualify for long-term gain treatment, only Sweden requires a longer holding period than does the United States. As can be seen in the summary table, Sweden requires a two-year holding period, the United States and Australia require one year, Germany requires six months, and the remaining countries grant the same capital gain treatment to both long and short-term gains. In other words, seven of eleven countries have, in actuality, no holding period whatsoever. Besides the U.S., only Australia and Sweden have holding periods of one year or longer.

COMPARISON OF INDIVIDUAL TAXATION OF DIVIDEND INCOME IN ELEVEN COUNTRIES

Country	Integration of Corporate-Shareholder Taxation+	Maximum Marginal Tax Rates*	Special Allowances or Exemptions Other Than Integration
United States	None	50%	$100 dividend exclusion for individuals for tax years beginning after 1981.
Australia	None	60%	Beginning July 1, 1983, 30% dividend exclusion ($300 maximum).
Belgium	Indirect	67%	Limited exemptions for dividends on Belgian shares purchased during 1982 and 1983.
Canada**	Indirect	17%	Annual exemption aggregating $1,000 ($816) for dividends, interest, and capital gains
France	Indirect	54.325%	Deduction for increase in annual investment in domestic stock. Dividend exemption of up to FF 3,000 ($409) for taxpayers whose taxable income does not exceed FF 260,000 ($35,438).
Germany	Direct	31.25%	None
Italy	Direct	53%	Special savings stock (similar to preferred but without liquidation preferences) taxed at rate of 15% at the source.
Japan	Indirect	70%	Lower taxation at source rates (20%-35%) for shareholders owning stock and receiving dividends within very liberal limits.
Netherlands	None	72.75%	Limited exemptions for qualified investment companies and Netherlands corporations
Sweden	None	54%	SKr. 800 ($107) deduction for individuals against income from capital.
United Kingdom	Direct	54%	None

+ Current tax law in most countries taxes corporate earnings twice, once through corporate taxes and again as dividend income when paid to shareholders. Integration is the tax method of reducing the burden of double taxation usually through reduced taxes to individual shareholders. For purposes of this table, we are defining direct integration as a system where the rate of corporate tax affects the shareholders' maximum tax rate and indirect integration as a system where individual shareholder tax rates are reduced by adjustments which are not directly related to the corporate income tax rate.

* State, provincial and local taxes not included.

** Provincial taxes in Canada approximate a 48% add on to federal tax.

COMPARISON OF INDIVIDUAL TAXATION OF DIVIDEND INCOME IN ELEVEN COUNTRIES

Only the U.S. and three other subject countries have not acted to reduce the tax burden on distributed corporate earnings. Some countries tax distributed earnings at a lower corporate rate. Most of the countries have adopted some kind of integration system to reduce the burden of double taxation of corporate earnings at both the corporate and shareholder level.

Japan has a maximum marginal tax rate of 70% on dividends. In practice, lower tax rates on dividend income may apply since shareholders owning stock and receiving dividends within certain limits can avail themselves of the taxation at source rules which tax dividend income at rates as low as 20%. Also Japan's integration system effectively reduces taxes at the corporate level on profits distributed as dividends.

Canada and Germany have a tax on dividend income at maximum marginal rates between 17% and 31.25%. Sweden, Belgium, Australia, France, Italy, and the United Kingdom have rates of between 53% and 72.75%. Further, both Belgium and France also have measures designed to encourage noncontrolling investments in stocks.

Seven of the countries have systems designed to reduce double taxation on corporate earnings, with both Germany and Japan providing lower overall taxation of profits paid out as dividends. The table opposite summarizes several features of dividend taxation in the eleven countries studied.

COMPARISON OF INDIVIDUAL TAXATION OF INTEREST INCOME IN ELEVEN COUNTRIES

Country	Federal Govt. Bonds	Corp. Bonds	Savings Accounts	Other Interest	Special Allowances or Exemptions
United States	50%	50%	50%	50%	Interest from state and local obligations is exempt from taxation.
Australia	60%	60%	60%	60%	None
Belgium	76.32%	76.32%	76.32%	76.32%	Interest earned on savings accounts tax-exempt up to BF 30,000 ($612)
Canada**	34%	34%	34%	34%	Annual exemption aggregating $1,000 ($860) for dividends, interest, and capital gains
France	25%+	25%+	45%+	50%	Corporate bond-interest tax-exempt up to FF 5,000 ($682)
Germany	56%	56%	56%	56%	Tax-exempt interest income on certain issues of long-term government bonds. Savings incentives for low-income individuals
Italy	Exempt	21.6%+	21.6%+	65%	Tax rate at source 10.8% for bonds of certain financial institutions and convertible bonds of companies
Japan	35%+	35%+	35%+	75%	Interest income on principal of 14.5 million Yen ($61,234) may be tax-exempt each year
Netherlands	72.75%	72.75%	72.75%	72.75%	Dfl. 700 ($254) interest income exclusion beginning in 1981
Sweden	54%	54%	54%	54%	SKr. 800 ($107) deduction for individuals against income from capital. Various special tax incentives
United Kingdom	75%	75%	75%	75%	None

* State, provincial and local taxes not included.

** Provincial taxes in Canada approximate a 48% add on to federal tax.

+ Represents lower taxation at source rates available at taxpayer's election.

COMPARISON OF INDIVIDUAL TAXATION OF INTEREST INCOME IN ELEVEN COUNTRIES

In considering the taxation of four major categories of interest in eleven countries, Belgium, the Netherlands, Japan, and the United Kingdom all have maximum marginal tax rates slightly exceeding 70%. However, Belgium and The Netherlands have interest income exclusions. Japanese residents may earn tax-exempt income on interest earned annually on certain combined deposits of up to $61,234 and can elect to have a 35% tax applied at most sources of interest.

France, Italy, and Canada tax most interest income at rates ranging from 20 to 40%. France has an exclusion for certain interest and Italy has a tax rate at the source of 10% for bonds of some financial institutions and convertible bonds of companies.

Australia, Germany, and Sweden have maximum marginal tax rates ranging from 54% to 60%. All these countries but Australia have exemptions or other devices to help reduce the ultimate tax liability. Of the 11 countries reviewed, eight have special exclusions, allowances, rates, etc. which reduce the effect of the maximum marginal rate.

The table on the opposite page summarizes several of the features of interest taxation in the eleven countries studied. In general, except as noted, the subject countries do not emphasize tax relief on interest income.

United States

Short-term gain (holding period of one year or less) and 40% of long-term capital gain are treated as ordinary income (maximum rate 50%).

Long-term capital gain may also be subject to the "alternative minimum tax," which is payable to the extent it exceeds the taxpayer's regular income tax liability (including the preference tax). The amount subject to the tax is the taxpayer's total taxable income plus the capital gain exclusion and other adjustments, reduced by a $20,000 exemption. The tax rates are as follows:

Amount subject to Alternative Minimum Tax	Tax Rate
First $40,000	10%
Over $40,000	20%

Tax legislation passed in 1976 altered the previous minimum holding period of six months and one day for long-term capital gain treatment to nine months and one day in 1977. A six month holding period had been in effect since 1942. The minimum holding period was increased to the present one year and one day in 1978. A tax bill enacted in 1978 changed the amount of excludable long-term capital gain from 50% to the present 60%. Also in 1978, the excluded amount was removed from its previous designation as a "tax preference item." At the same time, the capital gain exclusion was exempted from the 15% "minimum tax" on tax preferences and was eliminated as an adjustment of the amount of personal service income eligible for the "maximum tax" of 50% on earned income. The net effect of the 1978 changes was a reduction in the maximum effective tax rate on long-term capital gain from approximately 50% to 28% (not including any tax resulting from the application of the alternative minimum tax, also introduced in 1978). Tax changes in 1981 further lowered this effective rate to 20% by reducing the top marginal tax rate to 50% from 70%, i.e., 40% of long-term capital gain taxed at a 50% rate results in a 20% effective tax rate. The alternative minimum tax, as a practical matter, does not exceed this 20% effective rate.

Australia

A long-term capital gain (holding period of one year) is generally exempt from taxation. There are exceptions when the intention at the time of purchase was for resale at a profit or the property was acquired as part of a profit making undertaking or scheme. Short-term gain is taxed at ordinary rates (maximum 60%). There have been no significant changes in the taxation of capital gains on stock sales during the last seven years.

Belgium

The gain is generally exempt from tax regardless of the holding period. If the investment were of a "speculative nature," the gain would not be exempt; however, situations to which this exception apply are not common. Gains of a "speculative nature" occur when an investor on a continuing basis takes risks in excess of his net worth in order to make a profit.

Canada

One-half of the gain is taxed at ordinary rates (maximum 34%) regardless of the holding period which results in a maximum effective tax rate of 17%. Capital gain is also subject to provincial taxation which is calculated as a percentage of federal tax.

France

Generally, gain on the sale of portfolio investments is taxed at a flat rate of 15%. However, if during a year an individual receives proceeds from dispositions of securities amounting to less than FF 150,000 ($20,445*), the gain on all transactions will be exempt from taxation.

Prior to January 1, 1979, gain on the sale of portfolio stock investments was exempt from tax unless the gain was from sales of securities of companies engaged in real estate, in which case gain was taxed as ordinary income at graduated rates (maximum 60%).

Germany

Long-term capital gain (six month holding period) is exempt from taxation. Short-term capital gain is taxed at ordinary rates (maximum 56%).

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* Based on exchange rate of 1 FF = $0.1363 on April 22, 1983.

Individuals are subject to an annual wealth or net worth tax. Portfolio investments are valued at market value; the tax rate is .5%.

Italy

Under ordinary circumstances, gain on the sale of portfolio investments is exempt regardless of the holding period. Gain arising from "speculative" transactions is taxed as ordinary income at graduated rates (maximum 72%). This exception is rarely applied. Each case must be dealt with individually to determine whether the individual's intent was to acquire and hold the stock or to sell as soon as a reasonable profit could be realized.

Japan

Generally, the gain is exempt from tax regardless of the holding period. However, if during a year an individual enters into 50 or more transactions involving a total of 200,000 or more shares, all short-term gain (a holding period of five years or less) and one-half of long-term gain are taxed at ordinary rates (maximum 93% including local tax).

Netherlands

Capital gain is exempt from tax regardless of the holding period.

Individuals are subject to an annual wealth or net worth tax. A tax rate of .8% is applied to the net fair market value of assets, including portfolio investments. A deduction, however, is allowed for standard exemptions, which are Dfl. 48,000 ($17,410*) for single individuals Dfl. 96,000 ($34,819*) for each dependent child, and an additional Dfl. 43,000 ($15,596*) for individuals over 65.

Sweden

Forty percent of long-term gain (holding period of two years or more) and 100% of short-term gain are treated as ordinary income. Only 40% of short-term gain is includable in income when the gain is due to a compulsory sale (where an individual is forced by governmental authorities to dispose of an asset). In determining long-term gain on shares, individuals are allowed a tax basis equal to one-half of the net sales proceeds (if greater than actual cost) plus an additional standard deduction of SKr. 3,000 ($401+).

Individuals are subject to both a national tax (progressive rates up to 54%) and a municipal tax (maximum 33%), with the maximum combined tax rate being limited to 85% (on income exceeding SKr. 174,000 ($23,246+)). Capital losses are deductible only from capital gains and, subject to certain conditions may be carried forward for six years.

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* Based on exchange rate of 1 Dfl. = $0.3627 on April 22, 1983.

+ Based on an exchange rate of 1 SKr. = $0.1336 on April 22, 1983.

Prior to March, 1976, the includable amount of gain was as follows:

Minimum Holding Period Of Investment	Percentage of Gain Includable
2 years	75%
3 years	50%
4 years	25%
5 years	10%

Further, gains of up to SKr. 500 ($67) were tax free on shares held for five years or more.

Individuals are subject to an annual net worth tax on total assets owned with a total value in excess of SKr. 400,000 ($53,440+). Rates range from 1% on total asset values between SKr. 200,000 ($26,720+) and SKr. 275,000 ($36,740+) to 3% on amounts in excess of SKr 1,800,000 ($240,480+). Publicly held securities are valued at market value.

United Kingdom

The first £5,000 ($7,725*) of gain is exempt annually; a flat tax rate of 30% applies to gain in excess of this £5,000 regardless of the holding period.

Prior to April 5, 1977, an alternative tax was applicable under which one-half of the first £5,000 of gain was excluded from taxable income. The tax was computed as the

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+ Based on exchange rate of 1 SKr. = $0.1336 on April 22, 1983.

* Based on exchange rate of 1 £ = $1.5450 on April 22, 1983.

difference in the tax liability with and without the gain (causing the includable gain to be taxed at the highest marginal rates to a maximum rate of 98%, including a 15% surcharge). From April 6, 1977, until April 5, 1980, the alternative tax was 15% on gain from £1,000 ($1,545*) to £5,000, and 50% on gain in excess of £5,000. However, these alternative taxes applied only if they were less than the tax resulting from the application of the 30% flat tax rate.

One additional incentive which has just been renewed by the United Kingdom (as of April 6, 1983) is a program which encourages outside investment in new companies. The tax scheme allows an individual to deduct from taxable income the amount of his new investment in a small business in which he retains no more than a minority interest. This deduction is limited to £40,000 ($61,800*) annually.

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* Based on exchange rate of 1 £ = $1.5450 on April 22, 1983.

United States

Dividend income paid to individual shareholders is taxed twice: once at the corporate level, and again at the shareholder level. To mitigate this double taxation somewhat, each individual is given a $100 exclusion which may be used to offset dividend income. This exclusion applies only to tax years beginning after 1981.

Interest income is fully taxable, except for interest from state and municipal bonds which the federal government has no authority to tax.

Both dividend and interest income are included in an individual's taxable income which is subject to tax on a progressive rate scale. The maximum marginal tax rate on investment income is 50%.

Australia

Dividends from publicly held companies are treated as ordinary income and taxed at maximum marginal rates of up to 60%. This income is taxed twice: once at the corporate level, and again at the shareholder level.

For tax years beginning after June 30, 1983, individuals will be allowed a credit equal to 30% of their dividend income (limited to a total credit of $300). This is the only relief provided by the government to mitigate the effect of double taxation.

The tax on interest received from all sources within Australia, including savings accounts, corporate bonds and government bonds, is taxed at ordinary rates with no offsetting exemptions.

Belgium

Generally, dividends are subject to a 20% withholding tax. Individuals are entitled to a tax credit for the corporate tax paid on the dividend. The credit for the corporate tax is 51% of the net dividend (dividend minus 20% withholding tax). The corporate tax credit is limited to the total amount of tax paid by the individual on all unearned income. The withholding tax, however, is fully creditable and any excess is refundable. The taxable amount of the dividend is the dividend received grossed up (increased) by the credits for both the corporate tax and the withholding tax.

> To illustrate the above rules, if an individual receives $100 of dividend income, a withholding tax of $20 will be retained and the net dividend of $80 ($100-$20) will be received by the individual taxpayer. A dividend credit of $41 ($80 x .51) will be passed on to the individual shareholder. The individual shareholder reports income of $141 ($100 dividend + $41 tax credit). This income will be taxed at a maximum rate of 76.32% resulting in a total tax of $107 ($141 x .7632). The net tax is $67 ($107 less $41 credit) to which the withholding credit of $20 is applied. The maximum effective rate, then, is 67%.

In addition, dividends received on Belgian shares and representing cash capital contributions made during 1982 or 1983 are exempted from individual taxes. Generally, this exemption covers a period of five years; however, it may cover a period of nine or 10 years provided that the company has undertaken to respect some distribution obligations.

Interest from most sources, including corporate bonds and government bonds, is subject to a 20% withholding tax. This withholding tax is fully creditable and the excess, if any, is refundable. Interest subject to income tax is the amount received grossed up by the withholding tax.

Generally, interest earned on savings accounts with banks and recognized financial institutions is tax-exempt up to BF 30,000 ($612*). This income need not be reported.

Both dividends and interest are subject to federal tax at progressive rates up to 76.32%. However, the total effective burden (including city tax) cannot exceed an average bracket of 71.55% of total taxable income.

Canada

Currently, dividend income is grossed up (increased) by one-half of the dividend received. The grossed up dividend is fully included in taxable income and taxed at a maximum federal rate of 34%. The recipient is entitled to a tax credit equal to 68% of the amount of the gross-up.

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* Based on exchange rate of 1 BF = $0.0204 on April 22, 1983.

> To illustrate the above rules, if an individual receives $100 of dividend income, an amount equal to $150 ($100 x 1.5) will be included in taxable income. The total federal tax will be $51 ($150 x .340) and the tax credit will be $34 ($50 x .68). The net tax on the income will be $17 ($51 less tax credit of $34). This results in a maximum effective tax rate of 17%.

Prior to 1979, corporations could pay nontaxable dividends to shareholders if these dividends were distributed from income accumulated prior to December 31, 1971, on which the corporation had paid a special 15% corporate tax.

Interest income from savings accounts, corporate bonds and government bonds is included in taxable income and taxed at a maximum federal rate of 34%.

A deduction from income is allowed for dividends, interest and capital gains up to a combined maximum of $1,000 ($816*) Canadian dollars per annum.

The provinces also levy income tax on dividend and interest income. Provincial income tax (except for Quebec) is calculated as a percentage (38% to 58%) of federal income tax. It is collected by the federal government. Quebec administers its own tax collection but taxes dividends and interest in a manner similar to the federal government.

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* Based on exchange rate of $1 Can. = $0.8156 U.S. on April 22, 1983.

France

Dividend income is grossed-up (increased) by one half of the dividend received. The grossed-up amount is included in ordinary income and taxed at a maximum rate of 69.55%. In certain cases, recipients of dividends are granted a tax credit that is equal to one-half of the dividend received. A special exemption of the first FF 3,000 ($409+) of taxable dividends from French companies is available to taxpayers whose taxable income does not exceed FF 260,000 ($35,438+) before the exemption.

> To illustrate the above rules, if an individual receives $100 of dividend income, a total of $150 ($100 x 1.5) is included in taxable income. The maximum tax would be $104 ($150 x .6955). From this, an amount equal to the original gross-up ($50) may be subtracted from the tax of $104. This results in a net tax of $54 ($104 - $50). Dividend income, then, is taxed at a maximum effective rate of 54.325%.

In addition, the "Monory Law" of 1978 which established a deduction for the annual increase in an individual's investment in stocks of French companies quoted on the stock exchange was repealed as of January 1, 1983, except for persons over 51 on January 1st, 1983, who had already invested under the provisions of that law in 1981. It has been replaced by a more complex system in which a tax credit (instead of the former rebate of FF 5,000 ($682+) on the taxable income) is granted equal to 25% of net purchase of French companies' stocks. The tax credit is

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+ Based on exchange rate of 1 FF = $0.1363 on April 22, 1983.

limited to FF 1,750 ($239+) per year for a single taxpayer and to FF 3,500 ($477+) for a married couple (e.i., 25% of FF 7,000 or FF 14,000). This tax credit is not available to taxpayers liable to the wealth tax.

Generally, all types of interest income are taxed as ordinary income at a maximum federal rate of 69.55%. Interest received from negotiable corporate bonds is subject to a 10% withholding tax which is fully creditable and refundable. Also, the first FF 5,000 ($682+) of corporate bond interest is nontaxable in most cases. Taxpayers can also elect to have a specified amount of tax withheld in lieu of including interest received in the yearly computation of taxable income. The withholding rates vary from 25% for interest on government loans and negotiable loan securities to as high as 45% on savings deposits and 50% for bearer bonds.

Germany

Dividends are taxed at progressive rates up to a maximum of 56%. To avoid double taxation, resident recipients of dividends from a German corporation are allowed a credit for the allocable national income taxes paid by the German corporation. The corporate tax rate is 36%. The reduced corporation income tax rate applies to all distributions after 1976 whether from current year's earnings or from prior years' retained earnings. A distribution from retained earnings results in a retroactive

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+ Based on exchange rate of 1 FF = $0.1363 on April 22, 1983.

reduction of the allocable corporate income tax to 36%. Distributions from pre-1977 earnings do not qualify for the retroactive reduction.

> To illustrate the above rules, a German corporation distributes $100 of its income to an individual shareholder. The corporation pays $36 ($100 x .36) of income tax on the $100 dividend. The shareholder's dividend received, then, is $64 ($100 - $36) and he is allowed a credit for corporate tax paid of $36. The shareholder recognizes income of $100 ($64 + $36). The tax on this income will be computed at a maximum federal rate of 56%. The shareholder's net tax is computed as $20 ($100 x .56 = $56 less corporate tax credit of $36). This results in a maximum effective tax rate of 31.25%.

In 1983 and 1984 an additional, compulsory surcharge is collected. It amounts to 5% of the individual income tax if the taxpayer earns more than DM 50.000 (single; $20,425*) or DM 100.000, (married; $40,850*). A corporation has to pay 5% of its corporate tax prepayments but it can net this additional tax against certain qualifying investments. The amount will probably be refunded in 1987 - 1989. The new German government, however, might decide to refund only part of it.

Before 1977, Germany had a classical system of taxing corporate profits twice, first at the corporate level and again at the shareholder level with a credit for the dividend withholding tax.

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*Based on exchange rate of 1 DM = $0.4085 on April 22, 1983.

Interest income including that from savings accounts, corporate bonds and most government bonds is taxed at a maximum rate of 56%. Tax-exempt interest income is earned on certain issues of long-term government bonds.

Special savings incentives have been created but are limited to individuals with low annual income. For example, a special savings plan known as the "DM 624 Law" allows such individuals to direct their employers to pay up to DM 624 ($255*) of an employee's after tax salary into any qualified investment plan. This entitles the employee to receive a tax-free cash grant from the employer of 30 to 40% of the amount invested. The employer is then reimbursed by the tax authorities for the amount of the cash grant.

Italy

Beginning January 1, 1983, dividends from publicly-held corporations are taxed at a maximum federal tax rate of 65%. However, individuals are entitled to a tax credit for federal corporate tax paid (33.34% of corporate taxable income). This provision was originally introduced in 1977 in order to mitigate the effective tax burden on individuals.

> To illustrate the above rules, if an individual receives $100 of dividend income, a $33 credit for corporate taxes paid will also be available. The dividend will be taxed at a maximum federal tax rate of 65%. This results in an effective tax of $53 after the dividend

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* Based on an exchange rate of 1 DM = $0.4085 on April 22, 1983.

> received credit ($133 x .65 - $33 = $53). The maximum effective tax rate for dividend income, then, is 53%.

Dividends from special savings stock, issued by companies listed on the stock exchange, are subject to withholding of 15% as a final tax. Such stocks are similar to preferred stocks except that they have no preferences upon liquidation and are subject to other restrictions.

Interest income from government bonds is exempt from federal taxes. Interest from savings accounts and corporate bonds issued before September 30, 1982, is taxed at the source at a 21.6% rate. The tax rate at the source for corporate bonds issued after October 1, 1982, bonds of certain financial institutions and convertible bonds of companies is 10.8%. Other interest is taxable as ordinary income up to a maximum federal rate of 65%.

Japan

Japanese corporations with stated capital over 100 million yen ($422,300*) pay a lower tax on the portion of taxable income that is distributed as dividends. The corporate tax rate for distributed earnings is 32%. The rate for retained earnings is 42%.

Dividends are subject to a 20% withholding tax. If the gross dividends (including tax withheld) are less than 100,000 yen ($422), then the taxpayer may elect to be taxed at the source at the 20% rate. If the dividends are greater than 100,000 yen, they are normally includable in the recipient's taxable income.

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* Based on an exchange rate of 1 ¥ = $0.004223 on April 22, 1983.

Taxable income is taxed at graduated rates up to 75% (however, the total federal tax plus the local inhabitant tax, which is an additional 18%, may not exceed a maximum of 80%). A credit for the 20% withholding tax and a special dividend received credit are creditable against the tax. The special dividend received credit is 10% of the dividend received limited to 5% to the extent the dividends cause the recipient's taxable income to be greater than 10 million yen ($42,230). Therefore, an individual who receives 6 million yen ($25,338) in dividends and has a 12 million yen ($50,676) taxable income may claim 500,000 yen ($2,112) dividend received credit. This credit is computed: 5% of 2,000,000 (12,000,000 - 10,000,000) plus 10% of 4,000,000 (6,000,000 - 2,000,000).

> To illustrate the above rules, if an individual receives $100 of dividend income, the tax at the highest marginal rate would be $75 ($100 x .75). If the individual's other income exceeds $42,230, the dividend received credit will be a maximum of $5 ($100 x .05). This causes a maximum effective tax rate on dividend income of 70% (75% - 5%).

The interest earned on government bond investments of up to 3 million yen ($12,669) is tax-exempt. Interest income on savings deposits with the post office and bank deposits is also excludable on principal amounts of 3 million yen for each type of account. An individual may also earn interest tax free on savings of up to 5 million yen ($21,115) made through his employer. Finally, interest on amounts of up to 500,000 yen put aside for the acquisition of a personal residence are also tax exempt. In total, interest income on 14.5 million yen ($61,234) may be tax-exempt each year. Other interest income is taxed at ordinary rates to a maximum rate of 75%.

Alternatively, a Japanese individual may elect to have some dividend and interest income taxed exclusively at the source through a 35% withholding tax. To qualify for this election for dividends, the individual must own less than 5% of the outstanding shares of the payor company and must not receive more than 500,000 yen of dividend income from any one company per year. Interest income from time deposits and bonds qualifies for this election of taxation at the source.

Netherlands

Dividends are fully taxed at a maximum rate of 72.75%. Any tax withheld on the dividends can be offset against the income tax liability.

Interest income, including interest on savings accounts, government bonds and corporate bonds are also taxed at a maximum rate of 72.75%.

Since 1981, taxpayers get a Dfl. 700 ($254+) exemption for interest income and an exemption of Dfl. 1,000 ($363+) for dividends from certain investment companies. Beginning in 1981,

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+ Based on an exchange rate of 1 Dfl. = $0.3627 on April 22, 1983.

taxpayers also get a general exemption of Dfl. 500 ($181+) for dividends received from companies based in the Netherlands.

Sweden

Dividends and interest are included in ordinary income and taxed at a maximum federal rate of 54%. The total combined federal and municipal rate, however, is limited to 85%.

No dividend or interest income is specifically tax-exempt, but a tax deduction of SKr. 800 ($107*) for singles and SKr. 1,600 ($214*) for couples is allowed against income from capital.

The government also has various saving incentives in effect. A series of tax-exempt savings schemes allow taxpayers tax breaks for special bank deposits up to SKr. 4,800 ($641*). Additionally, taxpayers are allowed to invest up to SKr. 7,200 ($962*) per year in a mutual fund and take a tax credit equal to 20% of their investment. If an individual elects to participate in both of these incentive plans, his combined investment cannot exceed SKr. 7,200.

It is also important to note that these incentives are currently under review and likely to be reduced by the current government.

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* Based on an exchange rate of 1 SKr. = $0.1336 on April 22, 1983.

United Kingdom

The taxation of dividends at the corporate and shareholder levels has been integrated. If a corporation pays a dividend to its shareholders, the corporation must remit to the Inland Revenue a percentage of the distributed amount as the Advance Corporation Tax (ACT). The ACT is available for offset against the corporation's corporate tax liability on its income. The rate of ACT during the financial year ending March 31, 1981, is 3/7ths of the dividend paid. This rate can be changed periodically although it has been at this level since April, 1979.

The recipient of the dividend also receives a tax credit voucher equal to the pro rata ACT. The shareholder recognizes income equal to the dividend received plus the tax credit as shown on the voucher. The income is taxed at a maximum federal rate of 75% (60% plus a surcharge of 15%). The shareholder is allowed a tax credit for the amount of the ACT; the credit is refundable if the dividend income is sheltered by other deductions or allowances.

> To illustrate the above rules, if an individual receives $100 of dividend income, 3/7ths or $43 will be remitted to the Inland Revenue. The shareholder's taxable income is $143 ($100 + $43) and the gross tax is $107. ($143 x .75). The net tax would be $64 (tax of $107 less credit of $43), a maximum effective tax rate of 64%.

Interest income is taxed at a maximum federal rate of 75% (60% plus a surcharge of 15%).

APPENDIX B

SIA/DRI METHODOLOGY IN MEASURING THE REVENUE IMPACT OF A REDUCED HOLDING PERIOD

The Unlocking Effect of the 1978 Tax Cut

Experience since the change in the 1978 law is a starting point for evaluating the impact of a reduction in the holding period from 12 to 6 months. The change in realizations relative to the change in tax rates on capital gains can be measured and used as a standard to evaluate the impact of a reduced holding period. The data, using various series, show a sharp spurt in realizations following the reduction in the maximum tax rate in 1978. Clearly, the level of realizations since the reduction in the maximum tax rate on capital gains suggests substantial "unlocking." To estimate the magnitude of the unlocking effect, we estimated what realizations would have been if tax rates on gains had remained unchanged.

To be conservative, the percentage change in the S&P 500 since mid-1978 was used to inflate actual 1978 realizations, thereby deriving a hypothetical series of gains.1/ The S&P 500 Index as an inflation factor reflects increased realizations

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1/ The coefficient of determination (R2) between realizations and changes in the S&P 500 index was .71. DRI, using time series data, studied the relationship of realizations to GNP, changes in stock prices, changes in other economic variables, and the tax rate on capital gains. With the exception of stock prices; these variables did little to explain realizations. In fact, had these correlations been used to estimate what gains would have been under the pre-1978 law, "hypothetical gains" for 1979-81 would have been substantially lower than the realizations obtained by inflating for stock price trends.

attributable to higher market value and increased turnover.2/ Table I shows the hypothetical gains series derived by applying only the S&P 500 Index increases to 1978 actual gains. The difference between the hypothetical series and the actual series reflects the unlocking impact of the 1978 tax change. By applying the 18.32% effective tax rate on capital gains in 1978 to later years, we estimated what revenues would have been generated from capital gains if there were no change in law.

TABLE I

	Hypothetical Gains ($bils.)	Tax Rate	Theoretical Taxes Raised ($bils.)	Actual Gains ($bils.)	Actual Tax Rate	Actual Taxes ($bils.)
1978	N.A.	N.A.	N.A.	$50.5	18.32%	$ 9.3
1979	$54.2	18.32%	$ 9.9	73.4	15.62%	11.4
1980	62.5	18.32%	11.5	74.6	16.40%	12.2
1981	67.4	18.32%	12.3	78.0	14.80%	11.5

The hypothetical gain series was simulated in DRI's econometric model. If rates had remained unchanged from 1978, the government would have taken in about $1.9 billion less in individual tax revenues from 1979-81. In addition, a weaker economy would have resulted. For example, during 1979-81, real GNP would have been lower by $1.4 billion.

Changing the Holding Period

With a measure for the unlocking effect of reduced capital gains taxes established, there is a basis for estimating the

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2/ To account for the time period that investors held assets, a hypothetical series was derived assuming all investors held their gains prior to 1978 and another assuming that only a portion of investors realizing gains in 1980 and 1981 held their assets prior to 1978.

elasticity of capital gains realizations to changes in tax rates. In economic theory, elasticity is defined as a measurement of the relative change in quantity divided by the relative change in price, when both of these changes are infinitesimally small.[3] For our purposes, *elasticity coefficients* (see Table II) were calculated for the actual and hypothetical series by taking the percentage changes in realizations and dividing by the percentage changes in tax rates on capital gains. In this case, realizations are the quantity and tax rates, the price. Other things constant, the higher the tax rates on capital gains, the lower the realizations. Under the pre-1978 law, realizations would have been $54.2 billion instead of the actual level of $73.4 billion in 1979.

TABLE II

Elasticities
(% change in realizations /)
(% change in capital gains tax rates)

Year	% Change in Realizations	% Change in Tax Rates	e
1979	-26.2%	+17.3%	-1.514
1980	-16.2	+11.7	-1.380
1981	-13.6	+23.8	-0.570

The elasticities computed for 1979, 1980, and 1981 are the key to evaluating the responsiveness of realizations to a change in the holding period. In effect, such a change is a lowering of the tax rate on capital gains realized in months 7 to 12. We believe that if the holding period were 6 rather than 12 months, gains realized in months 7 to 12 would increase in relative terms by at least as much as the increase in realizations when tax rates on gains held for longer than one year were lowered in 1978. As there is no current data on what portion of capital gains are realized in months 7-12, the 1977 Treasury data was used. In that year (the holding period was 9 months), 5.6% of total gains reported were realized in months 9-15. That percentage was applied to both actual and hypothetical gains for recent years.

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[3] See George J. Stigler, *The Theory of Price*, Macmillan Company, 1956, p. 33.

A reduction in the holding period to six months represents a fairly steep drop in effective tax rates on capital gains realized in months 7-12. When the percentage change in tax rates is multiplied by the elasticity coefficients in Table II, a large percentage change in realizations would take place. Currently, the value of gains realized in months 7-12 under a 12-month holding period is very small. The research work of Steven Kaplan supports this position.4/ His findings indicate that individuals do not realize short-term gains unless such gains are offset by short-term losses, and that the holding period requirement for long-term gains may actually reduce government revenues by inducing taxpayers to take their losses as short-term and their gains as long-term. Existing data show that individuals realizing short-term gains do so within the first few months of the short-term holding period and "lock in" as the line distinguishing between short-term and long-term is approached.

4/ Steven Kaplan, "The Holding Period Distinction of the Capital Gains Tax," National Bureau of Economic Research, Inc., Working Paper No. 762, September 1981.

Revenue Impact of a Reduced Holding Period

A tax rate of 20% was arbitrarily chosen to illustrate the probable revenue impact of a reduced holding period. Assuming a 20% tax rate and using the original elasticities computed for 1979-81, the hypothetical gains realized in months 7-12 at a 20% tax rate were estimated (see Table III). Under these assumptions, the government would have raised $200 million in additional tax revenues for the years 1979-81, if the holding period were 6 rather than 12 months.

TABLE III

	Holding Period of Six Months			Holding Period of Twelve Months		
	Theoretical Gains Realized in Months 7-12 ($bils.)	Tax Rate on Long-Term Gains	Estimated Taxes Paid ($mils.)	Hypothetical Gains Realized in Months 7-12 ($bils.)	Tax Rate	Estimated Taxes ($mils.)
1979	$4.1	15.62%	$640	$2.4	20%	$480
1980	4.2	16.40%	690	2.9	20%	580
1981	4.4	14.80%	650	3.5	20%	700

Altering the Expansion Factors

The preceding work expanded the hypothetical series by the cumulative increase in the S&P 500 since 1978, which overstates hypothetical gains for 1980 and 1981 while understating the unlocking effect. Thus, to take account of purchases of assets in recent years, certain proportions were arbitrarily assigned. For example, of those investors realizing gains in 1980, it was assumed that 75% held the assets prior to 1978 and 25% since 1979. The result of the differences in expansion factors are shown in the hypothetical gains series in Table IV. With smaller expansion factors, there is a greater unlocking effect from the

1978 tax cut. Simulated in DRI's econometric model, the results indicate that, without the 1978 cut in capital gains taxes, the estimated revenue loss for 1979-81 would be $3 billion.

TABLE IV

	Hypothetical Gains ($bils.)	Tax Rate	Theoretical Taxes Raised ($bils.)	Actual Gains ($bils.)	Actual Tax Rate	Actual Taxes ($bils.)
1978	N.A.	N.A.	N.A.	$50.5	18.32%	$ 9.3
1979	$54.2	18.32%	$ 9.9	73.4	15.62%	11.4
1980	61.6	18.32%	11.3	74.6	16.40%	12.2
1981	64.2	18.32%	11.8	78.0	14.80%	11.5

Once again, the estimated results for the impact of the 1978 change can be used to measure the probable impact of a reduced holding period. The greater unlocking effect generates greater elasticities. Using the same methodology as discussed previously, we estimated that for 1979-81 a reduction in the holding period would have generated an additional $280 million in revenues. This estimate exceeds the earlier "most conservative" figure of $200 million.

In sum, the revenue effect (particularly negligible estimates subject to arbitrary assumptions) should not be the only consideration for evaluating the merits of a six-month holding period. Based on realistic and conservative assumptions, our methodology shows that the government would have raised at least $200-$300 million in additional revenues if a six-month holding period were in effect for 1979-1981. Other studies cited in this paper show that complete elimination of the holding period would also raise rather than lower tax revenues. All of these studies contradict small revenue losses estimated by various government staff which do not allow for additional investment and realizations by individuals because of a shorter holding period.

Mr. GUARINI. Thank you very much, Mr. Ball.

Mr. Albertine.

STATEMENT OF JOHN M. ALBERTINE, PRESIDENT, AMERICAN BUSINESS CONFERENCE, INC.

Mr. ALBERTINE. Thank you very much, Mr. Chairman.

Mr. Chairman, my name is Jack Albertine. I represent the American Business Conference. I would like to submit my testimony for the record and simply summarize it.

Mr. Chairman, the American Business Conference is an organization of the chief executive officers of firms that have revenues between $25 million and $1 billion and have doubled in size in the last 5 years—so-called midsized high-growth companies.

We are not new startups. This is not a venture capital organization. These are relatively mature but high-growth, midsized companies. In addition, Mr. Chairman, they represent the full spectrum of American industry, from high technology to firms which are very low tech but very successful companies.

Mr. Chairman, over the last 2½ years, we have been very interested in the question that has troubled the Congress of the United States throughout the 1970's, and that is the cause of the deceleration in the rate of growth of productivity in this country.

We undertook a study to look at that issue, Mr. Chairman, and we are convinced that the reduction in the rate of growth of productivity in the 1970's is largely a function of the reduction in the capital-to-labor ratio. We wanted to get at the heart of that issue because productivity performance is so critical in terms of international competitiveness, job creation, and the standard of living of the average American.

Dr. George Hatsopoulos of the Thermo Electron Corp., which is a member of the American Business Conference, along with a group of economists and engineers, and several other CEO's, and myself undertook a study of that productivity decline, and, Mr. Chairman, I would like to submit for the record a copy of that study, as well as the article in the Economist of April 30 which summarizes the study.

Mr. GUARINI. It will be so entered.

[The material referred to follows:]

HIGH COST OF CAPITAL: HANDICAP OF AMERICAN INDUSTRY

(By Dr. George N. Hatsopoulos [1])

1. INTRODUCTION

This paper examines the marginal cost of capital to U.S. corporations [2] from 1961 to 1981 and its effect on the factors that influence labor productivity, economic growth, the development of high growth industries, and competition with Japan.

Businesses obtain funds from equity and debt and invest these funds in three classes of investment: fixed assets, inventories, and accounts receivable. The cost of funds is much higher than the prevailing interest rates on corporate bonds because equity is more than twice as costly and three times as extensive as debt. For example, the interest rate on long-term bonds was only 4 percent in 1961, while the pretax cost of equity was 15 percent. By 1981, the cost of equity had risen to 35 percent. Nevertheless, U.S. corporations rely more heavily on equity rather than less costly debt because equity does not involve the firm obligation for repayment that is attached to debt.

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[1] Founding member of the American Business Conference; chairman of the board and chief executive officer, Thermo Electron Corp. This study was sponsored jointly by the American Business Conference and Thermo Electron Corp.

[2] The study addresses all U.S. nonfarm, nonfinancial corporations which account for about 80 percent of total output in the nonresidential business sector.

The real cost of business investments, which we shall call the cost of capital services, depends not only on the cost of funds but also on the benefits of increases in asset values due to inflation, the benefits of tax credits and depreciation allowances, and the cost of asset decay, i.e., real depreciation. Between 1961 and 1973, the real cost of capital services, i.e., the cost adjusted for inflation, was practically constant at about 15 percent. After 1973, it rose sharply to over 20 percent, and has remained at about this level ever since.

Since 1973, the cost of capital services has increased relative to the cost of labor by more than 20 percent. This adverse trend—capital increasing in cost at a rate faster than labor—is in sharp contrast to the record of the 1960's when the ratio (capital services to labor) declined by 27 percent as labor costs rose while cost of capital remained stable. This behavior has adversely affected the capital-to-labor ratio and labor productivity in the 1970's. As capital becomes more costly relative to labor, firms will tend to forego investments needed to boost labor productivity.

There has been no increase in corporate profitability to compensate for the rise in the cost of capital. In fact, the actual return on capital divided by the cost of capital services has exhibited a severe downward trend since 1974. This ratio has remained below 80 percent in each of the last eight years, including years of high economic activity such as 1979. The erosion in profitability relative to costs has severely weakened capital formation, and contributed to slow economic growth.

Passage of the Economic Recovery Tax Act of 1981 was heralded as a major breakthrough in reducing the cost of capital services for U.S. corporations. Our studies reveal that the overall impact of this legislation is much smaller than generally perceived. Moreover, some of the benefits granted in 1981 under the new accelerated cost recovery system (ACRS) have been eliminated by subsequent legislation.

An enormous gap exists between the costs of capital services in the U.S. and Japan. In 1961, the cost of capital services for U.S. companies was double that paid in Japan, about 15 percent versus 7 percent. After 1973, the cost of capital services rose abruptly in the U.S. but declined still further in Japan. By 1981, the U.S.-Japan ratio had widened to almost 4 to 1, 19 percent versus 5 percent.

High real costs of funds and capital services are especially damaging to long-term investments, such as new ventures, that involve many years of expenditures before any returns are realized. Only short-term projects having relatively low risks can be undertaken when the real discount rate for expected future earnings is as high as that now confronting U.S. corporations. By contrast, the negative real discount rate that exists in Japan has triggered an expansion of research, development, and other new venture activities in that country.

There are many possibilities for obtaining the needed reduction in U.S. cost of capital, including tax measures and the removal of certain institutional barriers. This paper identifies the significant elements of the cost-of-capital problem and provides data and analyses that may be useful in evaluating alternative solutions.

[The remainder of the report has been retained in the committee files.]

The Economist

Reprinted from The Economist issue dated April 30, 1983

BUSINESS BRIEF

America cannot afford its cost of capital

American businessmen have long complained that raising money is too expensive. Their arguments usually allude to real rates of interest which—taking triple A corporate bond yields minus the rate of inflation—are about 7%. In fact the real cost of capital is much higher. This week, Mr George Hatsopoulos, chairman of a Massachusetts high-tech company and a director of the Federal Reserve Bank of Boston, told the joint economic committee of congress that the real annual cost is close on 20% and has been at this level since 1974.

Backed by detailed research* from a team of businessmen, engineers and economists (including some from the Massachusetts Institute of Technology) Mr Hatsopoulos argued that this high real cost of capital (three times the level in Japan) is American industry's biggest handicap. It is smothering economic growth and innovation, and lies behind growing import penetration (especially from Japan).

Estimating the cost of capital is more complex than the stripping of inflation from bond yields. Capital costs depend both on where the capital comes from (debt or equity) and where it is going to (fixed assets, inventories or receivables). These different uses of capital have different tax allowances, depreciation rates, etc, which affect the overall cost. Chart 1 shows where non-farm, non-financial American companies have raised money since 1960, and what they have done with it.

The overall real cost of business investment has two ingredients:

- The basic cost of raising money—a weighted average of the cost of debt and the cost of equity. For the marginal cost of investment (the cost of one extra unit) the appropriate weighting is a company's target debt-equity ratio. This, says Mr Hatsopoulos, for the average American company, is 1:3.
- The costs and benefits arising from the different ways the money is used: depreciation, tax rates, investment allowances, inflation rates, and inventory obsolescence.

The overall cost of capital is a weighted average of the costs of money invested in buildings, land, inventories and net receivables (ie, unpaid bills). The weights come from the data in chart 1.

Getting it

The cost of fixed-interest debt is easy to measure: it is the triple A corporate bond yield. Working out the cost of equity is a little harder. Companies often use the reciprocal of the price-earnings (p/e) ratio as a surrogate. However, equity costs depend on many other factors, the most important being projected dividend growth. They can be high even when p/e ratios are high.

A better estimate of the cost of equity is the rate at which expected future dividends (as perceived by the company's management) must be discounted to arrive at the company's present stockmarket valuation. This way of working out equity costs is analogous to the way the cost or yield of a bond is worked out—namely, the rate at which its coupon stream must be discounted to arrive at the bond's current market value.

Equity costs fall when the market value of a firm's shares rise, because the rate at which the (unchanged) dividend stream has to be discounted falls. Companies often assume that financing investment through retained earnings is cheaper than through rights issues. But both sorts of equity cost the same in America where companies can repurchase their shares at market value.

The cost of equity (so defined) boils down to the sum of today's dividend yield and the projected dividend growth rate. The first is known; the second is the devil to forecast. Dividend growth for companies as a whole will depend on a host of factors: expected inflation; the projected real return on capital; and forecast tax, depreciation and investment allowance schedules.

The overall cost of capital depends on the relative use of debt and equity. Since 1961, the Hatsopoulos study finds that the ratio of debt to total capital rose from about 20% to a peak of 27% in 1972 before falling back to about 22% for the two years 1980-81.

This finding—that balance-sheet gearing is quite modest and is lower today than in 1972—is reassuring. But it contrasts with the diagnosis of other economists and brokers (such as Salomon Brothers) who have gnashed their teeth over a secular decline in equity ratios since the 1950s, and a current debt-equity ratio of almost one. How come?

Some of the difference arises because the Hatsopoulos group looks at companies' net debt (total debt minus liquid assets). The alarmists look at gross debt. The difference is material: in 1981 liquid assets were 20% of total debt. In addition, Mr Hatsopoulos eschews book valuation of debt. He revalues debt by multiplying book values by the ratio of the market value to the book value of bonds quoted on the New York Stock Exchange.

Equity costs are a much more important component of the total cost of money than bond yields. In 1981, the nominal pre-tax cost of equity was well above 30%; triple A bond rates were about 12% (see chart 2).

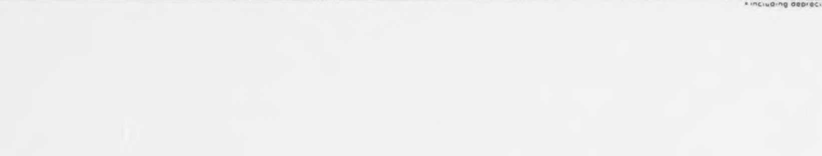
Since the level of the stockmarket is the key to the cost of equity, it is also a main determinant of the cost of capital. Wall Street's recent boom has done much more to reduce funding costs than the earlier fall in interest rates. The very sharp rise in the cost of money in 1974 was primarily a reflection of the stockmarket's plunge.

Equity is more expensive than debt for two reasons: risk and tax. Investors demand a higher return from equities because bondholders get an earlier crack at the assets of bankrupt companies. The premium on this risk is the gap between bond yields and after-tax equity costs.

Also, under the American (and most other) tax regimes, dividends are paid out of after-tax corporate income while interest is paid out of before-tax income. For equity and debt to command roughly comparable risk-adjusted yields in investors' portfolios, the pre-tax cost of equity has to stand at more than

Why capital costs more

All figures relate to US non-financial corporations



* including depreciation

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* High cost of capital: Handicap of American industry. By George Hatsopoulos, Thermo Electron Corporation, 101 First Avenue, Waltham, Massachusetts. Figures in our article are drawn from the study, which was sponsored by the American Business Conference.

twice the pre-tax cost of debt.

Why then do American companies rely so heavily on equity? Mainly, of course, because, come hard times, dividends can be pared and—in extremis—even passed. Bond interest and principal repayments must be met on the nail. But American corporate treasurers also rely on equity out of habit, ignorant of the fact that in 1981, when bond yields hit the roof (namely 14%), equity was even more expensive.

Using it

The cost of raising money is only one element in the overall cost of capital. Each way of using the money incurs a different net cost because of different adjustments for inflation, taxation, depreciation and investment allowances. For example, the cost of fixed assets (equipment and buildings) is the cost of capital plus the cost of depreciation less the benefit from tax credits and investment allowances and less the benefit from inflation.

Depreciation is the dominant factor. In 1981, for example, the real cost of equipment, excluding depreciation, was 9.4%—very close to the real cost of funds of 8.9% (the nominal cost less the expected inflation rate). But, with depreciation included, the real cost of equipment shot up to 23.3% (see chart 3).

Land is straightforward. It does not depreciate—anyway, the taxman does not recognise the possibility. So the real cost of land is the same as the real cost of capital. Effectively, so is the real cost of holding inventories. But the real cost of holding net receivables (unpaid bills) is the full nominal cost of money. Unpaid bills gain nothing from rising prices or tax breaks.

The overall real cost of capital is significantly higher than the real cost of raising money for two main reasons:

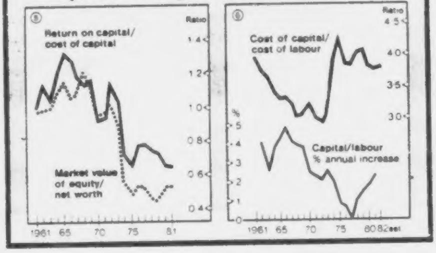
- Depreciation raised the cost of equipment and buildings by about 14 and six percentage points respectively in 1981.
- The cost of receivables is very high (about 30% in 1981) because there is no offset for inflation or tax.

Since 1960, about 60% of all capital raised has been channelled into equipment and buildings, in roughly equal proportions. The fraction spent on land has fallen sharply—from 17% to 10%. The slack has been taken up by inventories (up from 21% to 23%) and net receivables (up from 1% to 5%).

Relative costs have also changed. In 1961, the cost of financing equipment, buildings, land and inventories (net of depreciation) was similar. Since then, tax changes have been biased towards equipment. By 1981, the cost of financing buildings, inventories and receivables had risen by about 40%, 25% and 140%. The cost of buying equipment, by contrast, stayed put. This has favoured basic industries such as steel (which carry large fixed assets) at the expense of high-tech industries (which do not).

In the two decades to 1981, real capital costs rose from 15% to almost 20%. The big jump came in 1974. Of the 3.35 percentage points jump in that year, only 0.35 of a point was due to higher inflation. Three points reflected a steeper real cost of funds—mostly due to the stock-market's fall pushing up real equity costs.

The price of high capital costs



Over the whole 20-year period, a higher real cost of funds and higher inflation (which pushed up the overall real cost of capital by four points and nearly two points respectively) were mitigated by an increasingly liberal tax regime (which knocked 3.2 points off capital costs).

However, President Reagan's 1981 Economic Recovery Tax Act (which was heralded as a breakthrough) did not help much. A one-point rise in the after-tax cost of capital would be enough to wipe out its effects. Some of the act's benefits will anyway have been eroded by the belt-tightening 1982 Tax Equity and Fiscal Responsibility Act.

Regretting it

There have been at least four important consequences of the high real cost of raising money in America.

- The cost of capital has risen much more sharply than the cost of labour (see chart 6). The result is, although companies are still year-on-year employing more capital for each hour of labour, the capital-to-labour ratio is growing at only 1% a year compared with an average 3.3% a year before 1974.

Mr Hatsopoulos does not accept the argument that the substitution of labour for capital should be encouraged (eg, by abolishing investment incentives). He holds that the route to higher employment is through faster growth, which requires higher capital-labour ratios and which, in turn, waits on a lower real cost of capital.

- Corporate profitability has not increased to compensate for the rising cost of capital. The ratio of the return on capital to its cost has been falling since the mid-1960s (see chart 5). In every single one of the past eight years, the ratio has been less than 80%. Corporate America has not even been covering its costs. At the same time, the ratio of the market value of companies' equity to their net worth has plunged by 50%.

The collapse in equity values during the 1970s has led to the surge of acquisitions and takeovers. When the return on capital is less than its cost, new investment makes little sense. But the same investment, undertaken by snapping up an existing business, can be profitable if assets are acquired at well below replacement cost.

- American companies' high real cost of capital hurts their international competitiveness. Higher productivity in Japan, the Hatsopoulos report suggests, is at least in part due to higher capital investment (twice America's as a percentage of gdp) boosted by extraordinarily low real capital costs.

Until the oil crisis of 1973, the real cost of capital in Japan was about half what it was in America (see chart 4). Since then, the gap has widened. In 1981, the inflation-adjusted cost of capital in Japan was a mere 5½% against 19% in the United States. When depreciation costs are stripped out, the real cost of capital in Japan is consistently negative. This compares with a real rate in the United States of about 13%.

Two reasons for Japan's advantage: (i) Balance-sheet gearing is much higher (on average net debt is probably about 75% of capital employed). But in times of growth, Japanese companies' debt-to-capital ratios can rise well above 75%. Debt of 5-10 times equity is not unusual. (ii) The nominal cost of debt is very low, frequently below expected inflation.

Japan's capital-cost advantage is almost as significant as its better-documented wage-cost advantage. In 1981, says Mr Hatsopoulos, a typical product costing $10,000 to manufacture in America would cost only $4,900 in Japan. The lower marginal cost of capital accounts for 45% of the total cost saving of $5,100.

- American innovation is being squashed by high real capital costs. The economic value of new ideas is very sensitive to the cost of capital. That means that new technologies may be developed profitably in Japan yet remain uneconomic in America. The Hatsopoulos paper calculates that, in order to offset the benefits of lower Japanese capital costs, American venture capital companies need an (unthinkable) subsidy of $6 for every $1 that they raise.

How can America's high cost of capital be reduced? Mr Hatsopoulos is more concerned to identify the problem than solve it. But he does make two suggestions:

(a) Restore the benign macroeconomic conditions of the 1960s—4% inflation, low real interest rates and low equity risk premiums. That would reduce the real cost of capital to about 13½% (a little below the 15% cost of the 1960s owing to more generous capital allowances).

(b) Revamp the tax code. If dividends on cumulative preferred stock had, like interest payments, been tax-deductible the cost of capital to profitable firms would have fallen from 18.8% to 9.8% in 1981. That would have reduced Japan's capital-cost advantage on a product costing $10,000 from $2,300 to just $700.

Mr. ALBERTINE. Mr. Chairman, what we found was, I think, very, very important for this committee, and the Congress, and the issue we are addressing today.

We found that the major reason, in our judgment, for the reduction in the rate of growth of productivity is that the relative cost of capital in the United States has risen dramatically since the mid-sixties. When you look at the relative cost of capital in the United States versus our trading partners, particularly Japan, the numbers are absolutely astonishing.

Let me say with respect to this study that Paul Samuelson recently testified before the Joint Economic Committee and indicated he thought our numbers were absolutely correct, and Otto Eckstein of Data Resources, Inc., has also publicly said he thinks our numbers are absolutely correct.

We looked at the cost of capital differently than most economists have looked at it in the past. We found, for example, if you look at about 2,000 corporations in America that the debt-to-equity ratio in this country is about 1 to 3. Therefore, if you look, as economists have in the past, at just debt instruments, in terms of the cost of capital, you get a very distorted view of the true cost of capital.

In order to really understand what the cost of capital is in the United States, you have to understand what the cost of raising money through the equity markets is. Mr. Chairman, we undertook to do that. We looked at 2,000 corporations.

We constructed a little model to look at the present value of expected dividend streams to those corporations over the next 20 years. We looked at the weighted average of debt to equity in the United States, and then we calculated the true cost of capital as it faces American industry, as it faces American CEO's and workers in those companies.

In 1982, for example, the cost of capital in the United States was about 18 percent, significantly higher than the prime rate of interest, which has been one proxy variable economists have used in the past. The cost of capital in Japan, where the debt-equity ratios are almost the inverse of the United States, or about 3 to 1, was about 6 percent.

Now the implications for American industry are very profound. A project requiring 10 years of development time requires a probability of success five times as high in the United States as it does in Japan for us to justify undertaking it.

That means that we have to be at least five times as smart as the Japanese in order to be succeed in being competitive with them.

Mr. Chairman, the issue before us is very important. We need to reduce the costs of raising money through the equity markets. The best thing that has happened to the American economy in the last year has not been the drop in interest rates, and it has not been the revisions of accelerated depreciation. They reduced the cost of capital in a very minor way.

The most significant thing that has happened to American industry in the last year has been the increase in the prices of equity in the equity markets. That is why we think this issue of capital gains is so terribly important, because it affects in a critical way the cost of capital in America.

Thank you very much, Mr. Chairman.
[The prepared statement follows:]

STATEMENT OF DR. JOHN M. ALBERTINE, PRESIDENT OF THE AMERICAN BUSINESS CONFERENCE

Good morning. My name is Jack Albertine, and I am the President of the American Business Conference. The ABC is a coalition of the Chief Executive Officers of 100 mid-sized, high-growth companies. ABC member firms have annual revenues between $25 million and $1 billion, and each has doubled in size over the last five years. There are ABC members in almost every sector of American industry. They represent the most successful firms in this nation. Most were built from scratch by hard-working, innovative entrepreneurs. These visionary business people have a message for you on the critical importance of low-cost capital to the economic vitality of our nation.

The American Business Conference has just completed a study on the cost of capital and how it affects this nation's competitiveness in the world economy. I would like to submit for the record a copy of this study, High Cost of Capital: Handicap of American Industry, and an article about the study from the Economist. The study was prepared by one of our members, Dr. George Hatsopoulos, Chairman of the Thermo Electron Corporation, with the assistance of several distinguished economists.

Dr. Hatsopoulos shows that American industry, including the booming high-tech sector, will be in grave difficulty in the next ten years unless something is done to lower the cost of capital. You have before you two pieces of legislation—Congressman Beryl Anthony's proposal to reduce the holding period and Congressman Bill Archer's proposal to index the basis of some assets—which could significantly affect the level of U.S. industrial output for the rest of the twentieth century.

The American Business Conference became interested in capital formation, because we wanted to understand the reasons for this country's poor productivity performance in the 1970's. Productivity growth is crucial to maintaining our standard of living. Regardless of the rate of inflation, it is the rate of growth of productivity that determines the rate of improvement in our standard of living. As you know, productivity decelerated sharply in the mid-1970's. The principal reason for this was a decline in the main determinant of productivity, the ratio of capital to labor. On average, each worker had less capital to work with, so each produced less. The reason for the decline in the capital-labor ratio was a rise in the cost of capital relative to the cost of labor.

Over the same period when U.S. productivity was stagnant, Japanese productivity soared, and we began to cede our technological advantage to the Japanese. We believe that the primary reason for the erosion of our competitive position was that in 1973, while U.S. capital costs were rising, the Japanese government took steps to lower their capital costs. Today, the real cost of capital in the U.S. is more than three times that of Japan.

The Hatsopoulos study broke new ground in analyzing the true differential in capital costs. In previous studies, the cost of debt was used as a proxy for the cost of capital. Dr. Hatsopoulos determined that the actual cost of capital in the U.S. was a weighted average of the cost of debt and the cost of equity. Most U.S. firms have a target debt to equity ratio of about 1 to 3, so equity is much more important than debt in determining the cost of capital. The Japanese, on the other hand, rely more heavily on debt. Up to 90 percent of Japanese financing can come from borrowing.

Equity is much more expensive than debt. In 1981, the nominal pre-tax cost of equity was well above 30 percent, while the cost of debt was about 12 percent. The crux of the differential in the cost of capital between the U.S. and Japan (and other nations as well) is that U.S. corporations have to depend on expensive equity for 75 percent of their financing.

Thus, the level of the stock market is a major determinant of the cost of capital. The recent boom on Wall Street has done more to lower the cost of capital than has the much-heralded drop in interest rates. What this had to do with capital gains taxation is very simple. The last rounds of liberalization of capital gains taxes fostered a rise in stock prices and a concomitant drop in the cost of equity. Further moves in these areas, such as the adoption of the Anthony and Archer measures, should go even farther. Anything that can help the equity markets will help make U.S. industry more productive and more competitive.

It is, if you will, a domino effect. When you liberalize the tax treatment of capital gains, you encourage people to purchase equities. This lowers the cost of raising capital and allows business to invest more, thus raising productivity and creating jobs.

Let me add a warning about the scenario we could face if nothing is done to narrow the gap between the cost of capital in the U.S. and Japan. For an R&D project requiring 5 years of development and having the same probability of success in both countries, the disparity in the cost of capital now allows the Japanese to invest 2½ times as much as is economically justifiable in the U.S. For a project requiring 10 years of development, the Japanese can invest five times as much. In order to offset the benefits of lower Japanese capital costs, U.S. venture capitalists would have to receive a six dollar subsidy for every dollar they invest.

As you can see, the high cost of capital threatens to strangle our high tech sector. We are on the verge of being eclipsed by the Japanese and other nations, solely because their laws and investment practices permit vastly lower capital costs. Yet, it is within your power to hone our competitive edge by supporting more favorable treatment of capital gains and, in so doing, lowering the cost of equity in this country.

Thank you.

Mr. GUARINI. Thank you very much, Mr. Albertine.

Mark A. Bloomfield, executive director of the American Council for Capital Formation, we welcome you, sir.

STATEMENT OF MARK A. BLOOMFIELD, EXECUTIVE DIRECTOR, AMERICAN COUNCIL FOR CAPITAL FORMATION

Mr. BLOOMFIELD. Mr. Chairman and members of the committee, I am Mark Bloomfield, the executive director of the American Council for Capital Formation. I welcome the opportunity to comment very briefly on the 1978 capital gains tax cut experiment and then say a few words about future steps in capital gains tax reform.

Mr. Chairman and members of the committee, tax policy can be a primary vehicle whereby government can dramatically affect capital formation, the saving and investment necessary to stimulate productivity growth, restore real income gains and provide for new job creation. A dramatic shift toward procapital formation tax policy occurred in 1978 when members of this committee, including the late Congressman Bill Steiger, led the way to the substantial capital gains tax cut of 1978.

Skeptics at that time said it would do little for capital formation and it would do much to erode Government revenues. On both counts they have been proved dead wrong. First, the economics. We have two historical periods to compare—1969 to 1977, where we had high capital gains taxes and a bad investment climate, 1978 to the present, where we had lower capital gains taxes and a better investment climate.

What happened? In the latter period venture capital, new stock offerings, and the value of corporate equities blossomed. Why? We again restored the reward for risk-taking and investment.

Second, Uncle Sam's coffers. Government experts in 1978 predicted that year's capital gains tax cut would result in a $2 billion annual raid on the U.S. Treasury. What happened? After 1978 taxes went down on capital gains but revenues went up. Actual taxes paid on capital gains went up more than $2 billion in 1979, the first year of the lower capital gains tax rate, up again in 1980, and in 1981, the Treasury's most recent statistics show that actual revenues paid on capital gains were substantially higher than those in 1978, the last year under the old law.

Economists, however, also compare actual capital gains receipts with what would have happened if tax laws had not been changed. In a January 1983 study commissioned by our research affiliate, the ACCF Center for Policy Research, Dr. Gerald Auten, a former Treasury consultant on capital gains, compared capital gains taxes actually paid under the new law with taxes that would have been paid under the old law.

What did Dr. Auten find? He found that in 1978-79 revenues were up by more than $1 billion, in 1980 greater by almost $2 billion, and in 1981 over $1 billion higher than they would have been under the old higher capital gains tax rates.

Given the benefits to capital formation and also, I would suggest, to Uncle Sam's Treasury, much more needs to be done. The ACCF has long advocated the eventual elimination of the capital gains tax for individuals and corporations. To get there, however, in a practical fashion we support a balanced package of capital gains tax cuts of utmost importance and further reductions in the capital gains tax rates for individuals and corporations.

Other elements should include reducing the current corporate capital gains tax rate of 28 percent so that it is a gain equal to the maximum 20-percent rate for individuals indexing for inflation and eliminating or reducing the holding period.

Now a few comments about the latter two proposals. First, the existence of a capital gains tax itself reduces the availability of new investment funds. It results in the lock-in of existing capital and interferes with the free flow of economic resources. The current 1-year holding period exacerbates this lock-in.

Short of the optimal solution of the elimination of the capital gains holding period, Congressman Anthony's proposal would do much to reduce the effect of lock-in on investors, improve mobility and encourage efficiency in the capital markets.

Second, the impact of inflation on capital gains substantially increases the effective tax rate on real capital gains. Dr. Feldstein, in a 1978 study presented to this committee, showed how in 1973 taxpayers actually paid taxes on $4.5 billion of nominal capital gains, but after adjusting for inflation they really paid taxes on nearly $1 billion of losses.

Our January study confirms this pernicious effect of inflation. In the period 1971 to 1975, for example, taxable nominal capital gains on stock of $25 billion were really $420 million of real losses, with the impact most acute for lower- and middle-income taxpayers. Congressman Archer's proposal to index the basis for inflation would deal effectively with this problem.

Let me conclude by saying that this committee can choose among several worthy capital gains tax reform proposals, including those of Congressmen Archer and Anthony. The time is now right to seize the initiative once again and take action to further reduce the capital gains tax.

Thank you.

[The prepared statement follows:]

STATEMENT OF MARK A. BLOOMFIELD, EXECUTIVE DIRECTOR, AMERICAN COUNCIL FOR CAPITAL FORMATION

SUMMARY

1. A dramatic shift toward pro-capital formation tax policy occurred in 1978 when Congress reduced the excessive taxation of capital gains. Skeptics said this would do little for capital formation and erode government revenues. They were wrong on

both counts. First, the news on the economic front is encouraging. The amount dedicated to organized venture capital investment entities expanded from an average of $70 million per year in 1969–77 to an average of just under $1 billion in 1981 and $1.7 billion in 1982. Also, since the end of 1977, the value of corporate equities at market values has risen 83 percent; over $820 billion has been added to this value. In addition, new capital raised through initial public stock offerings climbed out of a lengthy depression following the 1978 capital gains tax cut. Second, the news on Uncle Sam's revenue is good. While estimates showed that the measure would cost over $2 billion in revenue, taxes paid on capital gains increased from $9.3 billion in 1978 to $11.7 billion in 1979, $12.5 billion in 1980, and $12.4 billion in 1981.

2. Despite the remarkable progress that has been made over the last five years in reducing effective capital gains tax rates, much more remains to be done. Current capital gains taxes levied on individuals and corporations have important consequences for economic growth. Capital gains taxes impact perversely on savings and investment, the availability of risk capital, the mobility of capital, the level of stock equity prices, and ultimately new job creation.

3. Recognizing the critical nature of the capital gains tax in the process of capital formation and economic growth, the American Council for Capital Formation has long advocated the eventual elimination of the capital gains tax for individuals and corporations. To move forward in that direction in a practical fashion, the ACCF supports a balanced package of capital gains tax reductions. Of utmost importance are further reductions in capital gains tax rates for individuals and businesses. Other elements include reducing the corporate capital gains tax rate of 28 percent so that it is equal to the maximum 20 percent rate for individuals, indexing the basis of capital assets for inflation, and eliminating or reducing the holding period for long-term treatment of capital gains.

4. The American Council for Capital Formation supports enactment of Congressman Beryl Anthony's proposal to reduce the current holding period for long-term treatment of capital gains from one year to six months and Congressman Bill Archer's bill to index the basis of certain assets for inflation. While both measures are significant positive steps forward, however, they should not detract from the ultimate goal of the elimination of the capital gains tax for individuals and corporations. The existence of capital gains taxes increases the bias in the tax system against saving and investment and diminishes the willingness and ability to save and invest, thus reducing the nation's potential for economic growth.

Mr. Chairman, and Members of the Committee, my name is Mark A. Bloomfield. I am the Executive Director of the American Council for Capital Formation. I appreciate the opportunity to present a comprehensive overview of the issues surrounding the Federal tax treatment of captial gains and losses.

The American Council for Capital Formation is a nonpartisan, nonprofit organization comprised of individuals, corporations, and associations united in their support of government policies to encourage the productive capital formation needed to sustain economic growth, reduce inflation, restore productivity gains, and create jobs for an expanding American work force.

Mr. Chairman, officers of the American Council have appeared often before your Committee over the years as you have considered legislation affecting saving and investment. We applaud the efforts of this Committee in bringing to the attention of your Congressional colleagues and the American public the critical relationship between capital formation and economic growth. This Committee has played a leading role in the development of legislation to set the stage for renewed productivity growth, real income gains, and expanded job opportunities.

We are pleased to appear before you again in support of legislation we deem vital to capital formation. The ACCF has a long standing interest and involvement in capital gains taxation, including the 1978 and 1981 capital gains tax reductions and the current debate on the measure advanced by Congressman Beryl Anthony. Congressman Anthony's proposal would shorten the long-term capital gains holding period from one year to six months and decrease the current $3,000 capital loss limitation to $1,000.

The American Council for Capital Formation has long advocated a full range of legislation to reduce and eventually eliminate the Federal tax on capital gains. There are many approaches that we support, including further reductions in the capital gains tax rate for individuals and corporations, indexing the basis of capital assets for inflation, cutting the current corporate capital gains tax rate of 28 percent so that it is equal to the maximum 20 percent rate for individuals, and reducing the holding period for long-term capital gains tax treatment. Each option has merit and each would move our tax system closer to the overriding tax reform goal of reducing the effective tax on capital.

RESULTS OF RECENT CUTS IN CAPITAL GAINS TAXES

Prior to 1969, there was a long period of relatively favorable long-term capital gains tax treatment; in 1969, however, major increases in capital gains taxes were considered and enacted. Throughout the 1969–1977 period, additional tax changes were made which were unfavorable for investors.

A dramatic shift toward pro-capital formation tax policy occurred in 1978 when members of this Committee, including the late Congressman Bill Steiger, and Congressmen Bill Frenzel, James R. Jones, and Ed Jenkins, among others, introduced legislation to reduce the excessive taxation of capital gains that was inhibiting saving and investment. That year, the maximum capital gains tax was cut from 49 percent for individuals (including the interaction of the old maximum and minimum income taxes) and about 31 percent for corporations (including the minimum tax) to 28 percent for both.

The 1978 capital gains tax reduction was the first of a series of changes which progressively reduced tax rates on individual capital. Other important steps include the reduction in the top rate on investment income from 70 to 50 percent, which eliminated the distinction between earned and unearned income, the expansion of Individual Retirement Accounts, the lowering of estate taxes, and the 25 percent reduction in marginal income tax rates in 1981–83 which also reduced tax rates on investment income and capital gains. The top tax rate on individual long-term capital gains has thus been reduced from just under 50 percent to 20 percent.

These recent changes in the U.S. Tax Code brought the taxation of capital gains closer to that of our international competitors. However, our capital gains tax rates and holding period requirement to qualify for long-term capital gains tax treatment are still harsher than those of most of the major industrialized countries. Table I attached gives international comparisons in the taxation of capital gains.

Early in the 1978 debate on the need to cut capital gains taxes, skeptics said that such measures would do little for capital formation and would erode government revenues. However, since 1978, considerable evidence of the salutary effects of reductions in taxes on capital gains has been documented.

First, since lower capital gains taxes increase the rewards for risk taking, it is understandable that those investment activities that involve the most risks, such as venture capital investment, would feel the sharpest impact of the change. In fact, the amount dedicated to organized venture capital investment entities expanded from an average of $70 million per year in the years 1969 through 1977 to an average of just under $1 billion per year in the years 1978 through 1982, with total dedications of $1.3 billion in 1981 and $1.7 billion in 1982. This is the nation's seed capital, from which hundreds of new companies are started each year.

Second, the performance of the equity markets has improved substantially. The nine-year depression in equity values which began in 1969 when tax rates on individual capital were raised significantly ended early in 1978, when the trend toward lower taxes on capital income began. Since the end of 1977, the value of corporate equities at market has risen 83 percent; over $820 billion has been added to this value. Other economic factors have most certainly been responsible for some of the recent increase, including the improved outlook for lower inflation, lower interest rates, and prospects for economic improvement. Yet gains throughout 1978–80 took place in spite of worsening inflation and rising interest rates. The common thread throughout the period has been the progressive reduction in tax rates on individual capital.

Third, new capital raised through initial public stock offerings climbed out of a lengthy depression in late 1978, and dramatic gains took place in 1979–81. Due to a less favorable stock market during much of 1982, there was some fall-off in that year, but offerings picked up sharply toward its close, and in the first six months of 1983.

Initial and periodic infusions of equity capital are critical for the successful development of new, young, and rapidly growing companies and for their capacity to generate new job opportunities. But many mature and large companies need to raise additional amounts of equity capital as well. The lengthy depression in equity values from which we are now emerging forced many companies to rely heavily on debt, particularly short-term debt. If these companies can replace some of this debt with equity, they will be in a better position to expand their facilities and their work forces as business improves. To the degree that the sale of equity can replace debt and meet the new financing requirements, some of the upward pressure will be taken off both short- and long-term interest rates which would further brighten the prospects for recovery.

Finally, opponents of lower capital gains taxes argued in 1978 that the reduction would cost the Treasury over $2 billion in revenue. The facts show that taxes paid on capital gains increased from $9.3 billion in 1978 to $11.7 billion in 1979, to $12.5 billion in 1980, and $12.4 billion in 1981.

In addition, economists have prepared simulations comparing the taxes actually paid with the taxes that would have been paid under the old law. Recent research by Dr. Gerald E. Auten, a Treasury Department tax policy consultant in a paper commissioned by the American Council for Capital Formation: Center for Policy Research, compared the capital gains taxes actually paid under the new law with taxes that would have been paid under the old law.[1] Dr. Auten's results indicate that under the new law, capital gains tax revenue was $1.2 billion higher in 1979, $1.8 billion higher in 1980, and $1.3 billion higher in 1981 than it would have been in the absence of the capital gains tax reductions.

The evidence thus far also indicates that so-called "fat cats" are paying more capital gains taxes than ever before. Those with incomes over $100,000 included $11.7 billion of net capital gains in adjusted gross income in 1979, an increase of 72 percent over the $6.8 billion reported in 1978. IRS data show the net gain included in income rose to $12.7 billion in 1980 for the high income group.

These facts make a convincing case in favor of reductions in capital gains taxes. But, have we gone as far as we can to ensure the maximum benefit to the American economy from lower capital gains taxes? In our judgment, the answer is a resounding "no."

THE NEXT STEP

Despite the remarkable progress that has been made over the last five years in reducing effective capital gains tax rates, much more remains to be done. Current capital gains taxes levied on individuals and corporations have important consequences for economic growth. Capital gains taxes impact perversely on savings and investment, the availability of risk capital, the mobility of capital, the level of stock equity prices, and ultimately new job creation.

Recognizing the critical nature of the capital gains tax in the process of capital formation and economic growth, the American Council for Capital Formation has long advocated the eventual elimination of the capital gains tax for individuals and corporations.

To move forward in that direction in a practical fashion, the ACCF supports a balanced package of capital gains tax reductions. Of utmost continued importance are further reductions in capital gains tax rates for individuals and businesses. Other elements include reducing the corporate capital gains tax rate of 28 percent so that it is equal to the maximum 20 percent rate for individuals, indexing the basis of capital assets for inflation, and eliminating or reducing the holding period for long-term treatment of capital gains.

Effective capital gains tax rates must be reduced. First, the existence of a capital gains tax reduces the availability of new investment funds, results in the "lock-in" of existing capital, and, thereby, interferes with the free flow of economic resources. This is particularly burdensome for small and medium-sized businesses for whom equity capital is difficult to acquire. The capital gains tax is an important consideration to investors both in terms of the desire and the ability to invest. By reducing the incentive for investment and adding to the cost of investment, the capital gains tax locks investors in. This added cost is levied not only on individual firms and investors but on society as a whole which is denied the benefits of a freely and efficiently functioning equity market.

The current holding period for long-term capital gains treatment exacerbates the "lock-in" effect of the capital gains tax. Analysts evaluating the effects of the current holding period requirements and the consequences of reducing it have concluded that the holding period distorts economic behavior and leads to economic inefficiencies. Many economists contend that the differential taxation of long- and short-term gains on the sale of assets causes a "lock-in" effect, because investors have a strong incentive not to realize short-term gains since they will usually be taxed at rates in excess of 20 percent (the current maximum rate for noncorporate investors). Thus, the "lock-in" effect may prevent capital from flowing to firms and industries where its productivity and returns to investors would be greater.

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[1] Auten, Gerald E., "The Taxation of Capital Gains: An Evaluation of the 1978 and 1981 Tax Cuts for Capital," New Directions in Federal Tax Policy for the 1980's (Cambridge, Massachusetts: Ballinger Publishing Co., October 1983).

The optimal solution to this aspect of the "lock-in" problem is the elimination of the holding period. As demonstrated in Table I attached, few of the major industrialized countries have a holding period distinguishing between short- and long-term gains. However, if elimination of the holding period is not possible, enactment of Congressman Anthony's proposal to cut the holding period to six months would reduce the effect of "lock-in" for many investors. It would do much to improve the mobility of capital, thereby, encouraging greater efficiency in the capital markets.

Second, the taxation of capital gains inhibits the willingness of investors to participate in "risky" ventures. Risk taking is a necessary adjunct to a free and competitive society. It is the catalyst for technological breakthroughs, new products and industries, and the revitalization of our existing industrial base. Unless there is a sufficient potential reward for investing in new ideas, innovative enterprises, and energy technology, investors will opt for greater liquity and safer investments. Preferential tax rates on capital gains in the U.S. and minimal or no taxes on capital gains elsewhere in the world have proved to be an effective risk-reward mechanism. The elimination of capital gains taxes for individuals and corporations in the U.S. world substantially increase the reward for risk-taking. Reductions in capital gains tax rates, as an interim step, could substantially increase the availability of venture capital and encourage this critical ingredient for economic growth and job creation.

Third, the impact of inflation on capital gains substantially increases the effective tax rate on real gains, creating a further barrier to saving and investment.

An impressive body of empirical work has been done, including the pioneering work of Dr. Martin Feldstein, now Chairman of the Council of Economic Advisers, and that of Dr. Gerald Auten cited earlier, showing the effect of taxing nominal gains is to increase substantially the effective tax rate on real capital gains.

Dr. Feldstein, in a 1978 study for the National Bureau of Economic Research,[2] showed that in 1973 individuals paid nearly $500 million of extra tax on corporate stock capital gains because of the distorting effect of inflation. His study also found that this distortion was greatest for middle income sellers of corporate stock. Specifically, the study showed that in 1973 individuals paid capital gains tax on more than $4.5 billion of nominal capital gains on corporate stock. If the costs of the shares were adjusted for increases in the consumer price level since they were purchased, the $4.5 billion nominal gain became a real capital loss of nearly $1 billion. Dr. Feldstein noted that as a result of this incorrect measurement of capital gains, individuals with similar real capital gains were subject to very different total tax liabilities.

Dr. Auten's study of the results of the 1978 and 1981 capital gains tax reduction analyzed nominal and real capital gains on corporate stock over income classes and found that, for assets sold between 1971 and 1975, the $25 billion of nominal capital gains on stock sold in this period actually represented a loss of $420 million after adjusting for inflation.[3] His study also showed that the problem was most severe for taxpayers in lower and middle income categories. The real capital gains of taxpayers with adjusted gross incomes over $500,000 were more than 80 percent of their nominal gains. However, taxpayers with incomes under $50,000 had nominal gains but substantial losses in real terms. Table II attached illustrates these effects.

Congressman Bill Archer introduced legislation in this session of Congress that would deal effectively with this mismeasurement resulting from inflation. His bill, H.R. 3651, would index the basis of certain assets for inflation, applying prospectively to most corporate stock and real property.

Finally, enactment of Congressman Anthony's holding period reform and Congressman Archer's indexing proposals, which significant positive steps forward, should not detract from the ultimate goal of the elimination of the capital gains tax for individuals and corporations. The existence of capital gains taxes increases the bias in the tax system against saving and investment and diminishes the willingness and ability to save and invest, thus reducing this nation's potential for economic growth.

CONCLUSION

The Revenue Act of 1978 ushered in a new era in the taxation of capital gains. Skeptics at that time said the 1978 capital gains tax cuts would do little for capital formation and do much to erode government revenues. On both counts they have proved wrong. The 1978 capital gains tax experiment was a success.

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[2] Feldstein, Martin, and Joel Slemrod, Inflation and the Excess Taxation of Capital Gains on Corporate Stock (National Bureau of Economic Research (NBER) Working Paper No. 234).

[3] See footnote 1 on page 6.

This Committee has before it several worthy capital gains tax reform proposals. The time is right now to seize the initiative once again and take action to reduce the capital gains tax.

TABLE I.—COMPARISON OF INDIVIDUAL TAXATION OF CAPITAL GAINS ON PORTFOLIO STOCK INVESTMENTS IN 11 COUNTRIES

Country	Percent		Minimum holding period to qualify for long-term gain treatment	Maximum annual net worth tax rate (percent)
	Maximum short-term capital gain tax rate [1]	Maximum long-term capital gain tax rate [1]		
United States	50	20	1 year	None.
Australia	60	Exempt	do	Do.
Belgium	Exempt	do	None	Do.
Canada	[2] 17	[2] 17	do	Do.
France [3]	15	15	do	Do.
Germany	56	Exempt	6 months	0.5.
Italy	Exempt	do	None	None.
Japan	do	do	do	Do.
Netherlands	do	do	do	0.8.
Sweden	54	22	2 years	3.
United Kingdom [4]	30	30	None	None.

[1] State, provincial and local taxes not included.

[2] Provincial taxes in Canada approximate a 48 percent add on to federal tax.

[3] Gains from proceeds of up to $20,445 (FF 150,000) are exempt from taxation in a given taxable year.

[4] The first $7,725 (£ 5,000) of gain is exempt annually.

Source: "Comparison of Individual Taxation of Long and Short Term Capital Gains on Portfolio Stock Investments and Dividend and Interest Income in Eleven Countries," prepared for the Securities Industry Association by Arthur Andersen & Co., June 1983.

TABLE II.—NOMINAL AND REAL LONG-TERM CAPITAL GAINS, 1971–75

Income class AGI in thousands	In millions of dollars						
	Number of returns with gains	Nominal gains	Real gains	Real gains by holding period			
				1–5	5–10	10–20	Over 20
Corporate stock sales:							
Negative AGI	87,887	186	–192	–209	–43	26	34
$0–$20	5,803,695	5,444	–3,792	–2,799	–2,920	–887	2,813
$20–$50	3,867,614	3,086	–4,546	–4,576	–362	266	126
$50–$100	803,178	4,504	1,012	–1,961	2,184	379	411
$100–$200	214,048	2,580	369	–1,434	420	672	711
$200–$500	47,011	3,309	2,083	–298	1,265	680	437
$500 and over	10,109	5,533	4,642	–22	2,289	1,305	1,070
Total	10,833,542	24,622	–420	–11,287	2,832	2,440	5,603
Real estate:							
Negative AGI	53,146	434	112	–29	126	9	6
$0–$20	1,032,134	3,544	1,120	397	–71	204	589
$20- $50	587,988	6,875	2,994	1,478	–61	85	1,493
$50–$100	85,539	1,148	528	78	200	85	165
$100–$200	29,771	740	297	208	61	71	–44
$200–$500	7,483	359	163	59	25	95	–16
$500 and over	1,181	121	82	10	24	27	19
Total	1,797,242	13,230	5,295	2,201	305	577	2,213
Residences:							
Negative AGI	8,849	2	–66	–7	–3	–14	–43
$0–$20	601,767	1,435	–1,623	–406	–481	–441	–295
$20–$50	259,745	1,239	–1,048	–96	–405	–255	–293
$50–$100	17,162	285	–19	7	16	–102	60
$100–$200	7,458	131	–18	20	6	–28	–18
$200–$500	1,540	21	–10	2	7	–17	–2
$500 and over	651	3	–.5	1	–.5	–.1	–1
Total	896,772	3,115	–2,785	–478	–859	–857	–591

TABLE II.—NOMINAL AND REAL LONG-TERM CAPITAL GAINS, 1971–75—Continued

Income class AGI in thousands	Number of returns with gains	In millions of dollars					
		Nominal gains	Real gains	Real gains by holding period			
				1–5	5–10	10–20	Over 20
Other transactions:							
Negative AGI	96,695	606	395	101	104	25	165
$0–$20	1,184,786	3,673	1,972	634	734	418	186
$20–$50	535,878	5,045	3,402	1,002	659	229	1,513
$50–$100	129,315	1,291	643	282	70	270	20
$100–$200	35,387	864	479	228	126	118	7
$200–$500	8,622	397	82	44	−45	75	8
$500 and over	1,333	174	86	38	32	13	3
Total	1,992,616	12,049	7,058	2,329	1,679	1,147	1,901

Source: Auten, Gerald E., "The Taxation of Capital Gains: An Evaluation of the 1978 and 1981 Tax Cuts for Capital," New Directions in Federal Tax Policy of the 1980's (Cambridge: Ballinger Publishing Co., forthcoming).

Mr. GUARINI. Thank you very much, Mr. Bloomfield.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman. I want to thank the panel and I wonder if any of you would care to comment on Mr. Chapoton's statement about the revenue losses.

Mr. Ball.

Mr. BALL. Mr. Duncan, I think that there is disagreement about whether the 6-month holding period in and of itself would raise or lower revenues.

What the securities industry is suggesting is that although we would like to see it happen in isolation we believe that investors are sufficiently concerned about the deficits that the coupling of a lower loss offset and a reduction in the holding period would add to Federal revenues by $1 or $2 billion without any disagreement over the next few years, that investors would welcome that change, and hence that even if the Treasury does not want to link the two for its public policy purposes the investing community would be delighted by it.

Mr. DUNCAN. Mr. Albertine or Mr. Bloomfield.

Mr. ALBERTINE. Mr. Duncan, as I pointed out in my testimony, the equity component is critical in terms of our cost of capital. I think the issue is whether or not we should be trying to make America more competitive in that regard and not what is going to happen to Federal revenues.

My own instinct is that together these two proposals probably will take care of that issue, but we are in such difficult straits on international competitiveness that we are likely to lose our technological edge to the Japanese and others, unless we reduce the cost of capital.

Given the nature of the financial system in this country that means reducing the cost of raising money through equity.

Mr. DUNCAN. Does American industry pay more for capital now than the Japanese?

Mr. BALL. Yes, sir, because of the difference in the debt-equity ratios. It is more expensive to raise money through equity than it is through debt because of the obvious case that the holders of equity bear a lot more risk than the holders of debt and one of the major factors is that our debt-equity ratio is about 1 to 3.

The Japanese are about the inverse, 3 to 1, and, therefore, the cost of raising capital in the United States is significantly higher than it is in Japan, which just simply means that American industry has less resources to put into the same kinds of projects that the Japanese can undertake.

Mr. DUNCAN. Thank you. I hope we can come to some conclusion on this matter at an early date. I want to thank all of you.

Mr. GUARINI. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. GUARINI. The prime sponsor of the bill.

Mr. ANTHONY. Mr. Ball, first of all thank you for your appearance and especially for your support for my original bill, but, more particularly, due to the fact that we are running into a revenue problem, thank your for your support of the amended version which enabled us to get where we are today.

Mr. BALL. Thank you, sir.

Mr. ANTHONY. I would like to ask you a question, but first I want to emphasize two points you made. You said that we should not be too concerned about protecting the shareholders from themselves. I think that is a point that needs to be reemphasized because the investor is the one who makes the decision as to when to either accept a loss or realize a gain.

There is nothing we, nor the Treasury can do to change this. All we can do is try to establish some correct tax policy so that it makes the process smoother.

With your poll you have actually shown that the investment community is not static and that there will be some behavioral changes. I am curious as to the date of the poll and without giving away any in-house trade secrets as to the number of clients that were included in the sample?

Mr. BALL. The sampling spanned 232 clients, which should be statistically quite valid. It was conducted on October 1 or 2 of this year and 79.3 percent of them said that they favored the linked measures. But simply as a throwaway and, by the way, from a tax standpoint it is more than a throwaway, those same investors believed that stock prices would rise by about 10 percent as a result of the lower loss offset and the shorter capital gains holding period.

The wording of the question was really quite impartial because our constituency is investors and we do not want to go off supporting a measure that is going to cause those who do business through Prudential-Bache to be furious with us.

A similar poll was done by a competitor firm, E. F. Hutton & Co., a few years back when I was affiliated with E. F. Hutton, and the results were very, very similar. By the way, they have never been published, but they were within a very small—they were in a very similar range.

Mr. ANTHONY. Well, I thank you very much. I think it is comforting to know that there is an investment community out there that understands and also supports our efforts in the Congress. Thank you.

Mr. BALL. We thank you, sir.

Mr. GUARINI. Mr. Matsui.

Mr. MATSUI. I just have a couple of questions for Mr. Ball. Mr. Ball, I take it that you—and perhaps you have not because this just came out—have seen the Joint Committee's report. Have you had a chance to look at the statistical information on both pages 7 and 14?

Mr. BALL. I saw it this morning and I am at least passingly familiar with it.

Mr. MATSUI. I am assuming you are disagreeing with them in view of the fact that you are saying this is probably going to be a revenue plus for the Treasury if we decrease the holding period from one year to six months. Is this correct?

Mr. BALL. Yes; the work we have done would indicate that there is a small plus. But we are saying however you count it, if you decrease the holding period and reduce the loss offset all figures would show a billion dollar plus.

Mr. MATSUI. Do you happen to have your study available that shows that there will be a revenue gain? I have not seen it. Perhaps it has been filed.

Mr. BALL. I do not know if it has been filed. We have thousands of copies. We would be delighted——

Mr. MATSUI. That is probably part of our record in any event.

You know, I think as far as—in a way not you but the Anthony proposal in final form now with the 6-month reduction plus the $3,000 to $1,000 offset to some extent has crippled Mr. Anthony because Treasury seems somewhat—well, very ambivalent to accepting that kind of a proposal. Obviously they would accept the 6 to 12, but not the $3,000 to $1,000 and there appears to be a disincentive if you do reduce the ordinary loss setoff.

What is your response to that?

Mr. BALL. Even though we have a former Wall Streeter now prominently displayed in the Treasury Department I think that for reasons of policy the Treasury is probably well advised not to get too formally involved in what are in the aggregate relatively minor matters to them that specifically do involve the investment community.

I think there is a sensitivity there which I appreciate and certainly we from Wall Street do not try to overextend our contacts in that area lest it be compromising to anyone. So their neutrality, their ambivalence, is something that I understand and appreciate.

Second, again I have to come back to the idea that investors are pretty good at making up their own minds. They do invest for gain and not to mitigate losses.

Mr. MATSUI. I am sorry. What was your sample again? I missed that. What was the sample?

Mr. BALL. It was 232 clients of Prudential-Bache Securities just taken at random, so I cannot promise that they were not all enormously rich or——

Mr. MATSUI. I certainly do not want to rely upon that in terms of my district and where I might stand politically, but it does not seem like much of a sample when you consider the number of investors in the country.

Mr. BALL. We believe that it is statistically valid and we would be happy to——

Mr. Matsui. You do not have a breakdown of the income levels of these people; is that correct?

Mr. Ball. That would be very awkward for us to do.

Mr. Matsui. But, you see, the problem with that, the $3,000 to $1,000 reduction will create a significant shift in terms of where the burden lies between those that make $50,000 and below and $50,000 and above, and I am wondering if there were many that were making $50,000 and below that were part of this 232 sample.

Mr. Ball. Two things quickly. Again, my guess very quickly is yes because our firm is basically macroinvestor. We would be happy to go back and——

Mr. Matsui. It is difficult for me to understand how these 232 could speak for the investors of this country because, you know, I know a lot of people that make $50,000 and below who invest in the market and you are obviously speaking for them today, and it seems a little difficult to imagine that with 232 people in the sample—can you respond to that? I would like to know.

Mr. Ball. Very quickly, we asked some of the mathematicians in our firm what it would take to be a statistically valid sample of our investors as a class, conform very closely to those in the stock exchange population overall, and they said something like 150, so we oversampled, to some extent. We can get that for you specifically. Again, I am pretty comfortable that it is representative.

Second, as to the difference between the impact of the shorter holding period and the loss offset, if you look back in years prior to 1982 when that latest table was compiled, the amount of reduction from a shorter holding period versus the amount of cost from a smaller loss offset would have flowed quite easily between those who earned under $50,000 and over $50,000.

My guess is that the 1978 act—and this is more than a guess, by the way; this is—I say it and I am pretty sure it is factual, it was the result of the sale of stock by venture capitalists who had put money in at times around the change in that holding period when things came to fruition and they recognized big, enormous, gigantic gains that caused their income levels, which may have been very modest, to suddenly become very high.

Frankly, I think that is a desirable impact, not an undesirable one. It was not just the rich paying lesser taxes.

Mr. Bloomfield. Could I comment on that chart in the Joint Committee report?

Mr. Matsui. Yes, I would appreciate that.

Mr. Bloomfield. I would like to comment on the chart in the Joint Committee report. What it assumes, unlike the 1978 capital gains reduction, is that there will be losses in revenue if you reduce capital gains. The Secretary is correct that there are some differences between rate reductions and the holding period reduction, but in a very accurate sense the holding period reduction is a reduction in the tax on assets held between 7 months and 12 months.

But with regard to this chart, let me focus on another——

Mr. Matsui. You are saying there will be——

Mr. Bloomfield. There is a rate reduction. It is a rate reduction for assets between 7 and 12 months. But instead of just focusing on projections, which is what this chart is, let us talk about by income classification what really happened when we reduced the capital gains tax cut.

What I would like to refer to is a document that a Dr. Martin Feldstein, the Chairman of the Counsel of Economic Advisers, released in April of 1983. What he did is look at the fact that realizations have gone up a hell of a lot since 1978 and there was a strong correlation between realizations and income class.

He had statistics going from 1977 to 1979. We have updated his work using the most recent Treasury statistics and we can tell you the breakdown by realizations, by income group, between 1977 and 1981. You cannot do it by taxes paid because the Treasury Department does not break down taxes paid by income class on capital gains.

Looking at realizations by income class from 1977 to 1981 you will find that realizations went up from $30 billion in 1977, the last year before the substantial capital gains tax cut in 1978, to $68 billion in 1981. That was an increase in realizations of 126 percent. If you break it down by income class you will find the taxpayers with adjusted gross incomes of less then $50,000 had increased realizations of 62 percent, and those with AGI's over $50,000 had increased realizations of 200 percent and they obviously were at higher tax rates.

Mr. MATSUI. I am not disputing your statistics. I am sure they are accurate. The problem is that Mr. Chapoton, if I may just have 30 seconds, Mr. Chairman, Mr. Chapoton, at least the implication that I received from his testimony today is that you are comparing apples and oranges. He stated that the difference between the holding period and the rate reduction is two different things, and that is why your statistics are valid but they may not have the kind of influence you want them to have if you believe Mr. Chapoton's assumptions.

And I suppose that is the problem I have, especially if you merge the two issues, which I have a particular problem with in this situation.

Mr. GUARINI. Thank you.

Mr. Bloomfield, just let me for the record ask you one question. In your testimony you stated the ultimate goal is the elimination of the capital gains tax for individuals and corporations, is the full thrust of your philosophy. Is that correct?

Mr. BLOOMFIELD. In an ideal world.

Mr. GUARINI. Should, then, in this ideal world an individual whose only income is from capital gains bear no cost of Government whatsoever under your philosophy?

Mr. BLOOMFIELD. My view is that we should move in the direction of all our major industrial competitors, and that is not have a tax system which penalizes saving and investment.

And also with regard to your point, I think you can come up with a consumption based tax system which has rebates and credits for lower income people.

Mr. GUARINI. The bottom line is—what you would say then, is that if a person has only income through capital gains and does not work otherwise by the sweat of his brow for a living—as middle America has to do in order to provide the cost of Government—

that that would be the objectives and the policies of the American Council for Capital Formation? Is that correct?

Mr. BLOOMFIELD. I would support a tax system which does not penalize saving and investment, and not just capital gains.

Mr. GUARINI. All right. Thank you, sir, and I want to thank Mr. Ball, Mr. Albertine, and Mr. Bloomfield for their testimony and advice. Thank you very much.

I would like to call the next panel—Chicago Board of Options Exchange, Samuel C. Thompson, Jr., counsel, acompanied by Arne Rode, general counsel; and the American Stock Exchange, Richard O. Scribner, executive vice president for legal and regulatory affairs; and the Options Policy Association, John S. Nolan, general counsel.

We welcome you gentlemen and would appreciate, as soon as you get settled, your testimony and we will start with Mr. Samuel C. Thompson, Jr., who is counsel to the Chicago Board of Options Exchange.

Mr. Thompson, whenever you get settled and you are ready we would be very happy to have you start your testimony.

STATEMENT OF SAMUEL C. THOMPSON, JR., COUNSEL, CHICAGO BOARD OPTIONS EXCHANGE, INC., ACCOMPANIED BY ARNE RODE, GENERAL COUNSEL

Mr. THOMPSON. Yes, Mr. Chairman. My name is Samuel Thompson. I am with the law firm of Schiff, Hardin & Waite in Chicago and I am tax counsel to the Chicago Board Options Exchange, Inc. and I am here today to talk with this committee about our legislative proposal.

Mr. Arne Rode, the general counsel of the Chicago Board Options Exchange, is here with me and after my brief comments he would like to make some points that are of particular concern to the Exchange.

On August 15 of this year the Chicago Board Options Exchange submitted to the Treasury Department a legislative proposal dealing with the taxation of options. First let me speak to the purposes for that proposal.

Today futures and options are taxed differently. Futures are taxed more favorably or at least there is a perception that futures are taxed more favorably. Because of the competition between futures and options, we at the CBOE are concerned about the competitive impact, the potential adverse competitive impact on our products if our products are not taxed the same as futures.

So the first thing we are concerned about, the first reason for our proposal is to eliminate the tax disparity in the taxation of futures and options.

Mr. GUARINI. What about the greater instead of the lesser? Would you accept that?

Mr. THOMPSON. Sir, are you suggesting that——

Mr. GUARINI. Treasury has testified that we up the taxes to the higher level so that futures and options be treated at the same level.

Mr. THOMPSON. Sir, I do not believe Mr. Chapoton today has suggested that the 60-40 rate be moved to 50 percent.

Mr. **Guarini**. To 32 percent.

Mr. **Thompson**. The 60-40 results in a 32 percent, sir, for futures.

Mr. **Guarini**. That is right.

Mr. **Thompson**. Mr. Chapoton merely suggested moving stock options into the disallowance of loss rules. He did not suggest leveling the playing field with respect to rate.

Mr. **Guarini**. All right, but I assume that competitive he would like to see them on the same playing field.

Mr. **Thompson**. Competitively we would like to see them on the same plane. We would like to see them mark-to-market. We would like to see them taxed at a 60–40 rate. We think that that is a fair and just resolution of this very difficult problem.

Sir, let me point out——

Mr. **Guarini**. Proceed. I am sorry to have interrupted.

Mr. **Thompson**. The second purpose for our proposal was to address concerns that Treasury expressed about the utilization of stock options straddles for deferral of short-term capital gains by investors and for deferral of ordinary income by market maker partnerships.

Our proposal addresses those concerns. Indeed, several years ago, shortly after the enactment of ERTA, we suggested to Treasury that they do something about the market maker partnerships because we identified those at the Exchange as a potential problem.

Sir, let me turn to the effect of our proposal. It is very simple in concept—that is, we simply wrap various kind of exchange traded options into 1256 which governs futures contracts. As a result, these products would be mark-to-market, given 60–40 treatment, and all of the rules that apply to futures would apply to options.

This would apply across the board, not only to investors but to our professional options traders. These rules are similar to the rules that apply to professional commodities or futures traders. The professional commodities trader gets mark-to-market and 60–40. We want our professional options traders to be mark-to-market and given 60–40 treatment.

The second effect of our proposal is to move stock options and stock into 1092, but we need an explicit exception for covered call transactions which are legitimate, bona fide transactions. Non-deep-in-the-money covered calls are not balanced positions, so they do not give rise to the concerns that Congress addressed in ERTA. And also they are not tax avoidance devices.

The third effect of our proposal would be to clarify the treatment of index options and commodity options.

Fourth, let me point out that it is generally agreed that our proposal would be revenue-positive. It would generate additional revenues.

Let me point out, sir, that on Monday the Senate Finance Committee took——

Mr. **Guarini**. Go ahead. You can finish your comment.

Mr. **Thompson**. Sir, on Monday the Senate Finance Committee adopted a proposal with respect to stock options. The proposal includes stock options in the straddle rules but does not move them into the rules dealing with futures and it treats commodity options as regulated futures contracts. In other words, it strips off commodities options and moves those into the world of futures.

We would urge this committee to refuse to agree to include commodity options in the futures world without also including stock options and other options products in the futures world. Our position is that if we are not going to move to 1256 or futures treatment for all options products, then all options products should be taxed under the current rules regarding options products.

Sir, let me simply sum up by saying that we think that our proposal is sound tax policy. We think that it solves the Treasury's concerns with respect to tax straddling, and we think that it levels the playing field, allowing investors to make rational decisions with respect to derivative products.

Thank you, sir.

[The prepared statement and additional material follow:]

STATEMENT OF SAMUEL C. THOMPSON, JR., ON BEHALF OF THE CHICAGO BOARD OPTIONS EXCHANGE, INC.

I am Samuel C. Thompson, Jr., a member of the Chicago law firm of Schiff Hardin & Waite. I appear today on behalf of the Chicago Board Options Exchange, Inc., the largest options exchange in the country.

On August 15, 1983, the Chicago Board Options Exchange presented to the U.S. Treasury Department a legislative proposal to extend to all listed option contracts the mark to market rules and 60/40 tax treatment currently applicable to regulated futures contracts. This proposal would: (*a*) Provide a consistent federal income tax regime for the taxation of options on securities, futures and options on futures, and (*b*) Eliminate the possibility of using stock option straddles to defer short-term capital gain or ordinary income.

Copies of this proposal have been submitted to the staffs of the House Ways and Means Committee, the Senate Finance Committee and the Joint Committee, and we have met with each of these staffs to brief them on this proposal.

The original proposal would have allowed taxpayers to elect to have listed option contracts taxed under the same rules as regulated futures contracts; however, the Chicago Board Options Exchange now supports a mandatory, non-elective mark to market and 60/40 tax treatment for listed option contracts.

Under this proposal, listed option contracts, like regulated futures contracts, would be marked to market at year end and gain or loss would be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. a listed option contract would be defined as any debt, stock, index, or currency option traded on a domestic exchange and any commodity option traded on a board of trade.

These changes would be implemented within the current sections of the Internal Revenue Code, and all of the rules governing regulated futures contracts would apply to listed option contracts.

The proposal would also amend the loss deferral rules enacted by Congress in 1981 to delete the exemption for stock options. The purpose of this proposed amendment is to include within the definition of offsetting positions stock options and stock which is offset by an option where the loss on one leg is essentially balanced or offset by the gain on the other leg.

The amendment to the loss deferral rules would exclude from the definition of offsetting positions non-deep-in-the-money covered call transactions. A covered call transaction is an investment strategy that is designed to increase total inventment return in respect of stock or securities held by an investor. In this strategy the investor writes call options with respect to such stock or securities. This commonplace and popular investment strategy is used today by individuals, mutual funds and pension funds to increase portfolio returns.

This options trading strategy does not provide an investor with substantial protection against the risk of loss from owning the underlying stock or securities. Non-deep-in-the-money covered call transactions are not balanced positions and are not tax avoidance devices; therefore, the exclusion of these transactions from the loss deferral rules is consistent with the intent of Congress in 1981 to prevent the manipulation of balanced positions for tax avoidance purposes.

Finally, the proposal of the Chicago Board Options Exchange would amend the Code to clarify the taxation of cash settlement options and to resolve the current dispute over the taxation of commodity options. Both of these financial products were introduced into the public markets after Congress enacted the rules governing regulated futures contracts and straddles in 1981.

During the time since we presented this proposal to the U.S. Treasury Department, representatives of the Chicago Board Options Exchange have met with U.S. Treasury Department revenue estimators. As a result of these meetings, a tentative conclusion has been reached that the proposal would increase tax revenues.

This informal revenue study also suggests that any revenue loss from taxing gains at a lower effective tax rate would be approximately offset by the revenue gain from converting 60 percent of the short-term capital losses to long-term capital losses.

These proposed amendments are sound tax policy. The amendments are designed first, to eliminate certain perceived tax abuses which have occurred since 1981 and second, to provide one consistent tax regime for comparable financial products.

The Treasury recently suggested that Congress shut down market maker partnerships in stock options which produce ordinary losses to offset income of wealthy investors and suggested that Congress re-examine the stock option exemption from the straddle rules, which permits investors to defer the taxation of unrelated short-term capital gains.

This proposal would specifically address the Treasury's concerns by eliminating the potential (1) for limited partners of market maker partnerships in stock options to defer ordinary income and (2) for investors in stock options to defer short-term capital gains. Also, we believe this proposal is the least complex statutory scheme for addressing the Treasury's concerns.

The need for one consistent tax regime for comparable financial products is also addressed by this proposal. Ten years ago there was virtually no connection between the financial products traded on commodity exchanges and those products traded on security exchanges. During the past few years, however, both the commodity exchanges and the security exchanges have developed a host of new trading instruments which directly compete with each other. For example, there are now both commodity futures and security options based on U.S. Treasury securities, stock indices and foreign currencies.

The degree of competition between regulated futures contracts and options intensified during 1982 and 1983 with the introduction of regulated futures contracts and options on stock indices. As one example, futures on stock indices have been used extensively by participants in the stock and stock options markets to speculate on stock prices and to hedge stock positions.

Dr. Frank J. Jones of the New York Stock Exchange has noted that: With respect to speculation, many stock and stock options market investors who had never participated in the futures markets in the past have become active in the stock index futures markets. Stock market professionals have used the stock index futures markets to hedge risk arbitrage transactions, stock underwriting, and block positioning. In addition, pension funds and other institutions have used the stock index futures markets to hedge their portfolios.[1]

Of course, stock options are also used to speculate on stock prices and to hedge stock positions.[2] Thus, participants in the securities markets use both stock index futures and stock options to perform many of the same functions.

This competition between futures on stock indices and stock option products has been acknowledged by the Federal Reserve Board which, in considering margin requirements for futures contracts based on stock indices, has said: [T]he Board took into account that stock index futures contracts can, to an important degree, compete with, and be an economic substitute for, stock options, on which margin requirements are currently imposed. In addition to limiting the use of speculative credit, margin requirements, therefore, may be appropriate to assure competitive equality among functionally similar instruments.[3]

Even though these competing products are economic equivalents, the current tax regimes governing these financial products produce substantially different federal income tax results. The simple example of an investor who realizes a gain of $1,000 during one trading day by buying and selling a futures contract on the one hand and an option on the other illustrates this disparate tax result. The investor who buys and sells a regulated futures contract is subject to a maximum tax of $320; whereas, the investor who buys and sells an option is subject to a maximum tax of $500.

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[1] Dr. Frank J. Jones, Senior Vice President, New York Stock Exchange, Inc., "Stock Index Futures and Options" (1983).

[2] See Report of the Special Study of the Options Markets to the Securities and Exchange Commission, 96th Cong., 1st Sess. 106-114, 159-63 (1979).

[3] Release issued by the Board of Governors of the Federal Reserve System, February 24, 1982.

This disparate tax treatment has been noted in the financial press. For example, in the October 1983 issue of Money Magazine it is said:

Today, options and futures contracts are taxed differently, even though they are similar. Both are bets on the future . . . . Gains are taxed at a maximum rate of 32 percent for futures and 50 percent for options. Traders in futures can deduct up to 70 percent of their losses, while options traders sometimes can deduct their entire losses. As a result, a person buying, say, a Treasury-bond call option and a Treasury-bond futures contract faces very different tax bills.[4]

There is no sound tax policy which supports these inconsistent tax results, and this legislative proposal would eliminate the inconsistencies. It is the view of the Chicago Board Options Exchange that the continuation of this inconsistent tax treatment could have a serious adverse impact on the viability of its option products.

At the time the Chicago Board Options Exchange presented its legislative proposal to the Treasury, the Exchange expected broad-based support from the securities industry. Recently, however, certain segments of the securities industry have expressed reservations about particular aspects of the proposal. One member of the securities industry has even suggested that equity-based futures be excluded from the definition of regulated futures contracts.

After considering the comments of these securities industry members, the Chicago Board Options Exchange continues to believe that its legislative proposal is both sound tax policy and the appropriate legislative response:

The proposal would eliminate the potential tax avoidance transactions identified by the Treasury without affecting legitimate economic transactions such as the non-deep-in-the-money covered call.

The proposal is the least complex statutory scheme for addressing the Treasury's concerns.

The proposal would eliminate the present inconsistent tax treatment of comparable financial products.

The proposal would clarify the tax treatment of newly created financial instruments.

Finally, the proposal would generate additional tax revenues.

The Chicago Board Options Exchange would like to express its willingness to assist the Congressional Committee staffs and the U.S. Treasury Department in resolving any current problems with the tax regime governing regulated futures contracts.

Finally, if Congress decides not to enact this legislative proposal during 1983, we believe Congress should only enact legislation this year to clarify that cash settlement options and commodity options are taxed under rules analogous to stock options. The broader tax issues addressed by this proposal could then be taken up in 1984.

Thank you.

---

[4] Money Magazine, October, 1983 at 232.

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August 15, 1983

The Honorable John E. Chapoton
Assistant Secretary (Tax Policy)
United States Department of the Treasury
Room 3112
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Legislative Proposal for Taxation of Listed Option Contracts

Dear Mr. Chapoton:

On behalf of the Chicago Board Options Exchange, Inc. (the "CBOE"), enclosed is a memorandum that sets forth a legislative proposal that would (A) eliminate the possibility of using stock option straddles for the deferral of short-term capital gain by investors and the deferral of ordinary income by limited partners of a "syndicate," and (B) provide a consistent federal income tax regime for the taxation of options and futures. This proposal would be implemented within the current Code sections governing options and futures:

(1) Stock options (and stock to the extent offset by options) would be included within the present loss deferral rules of section 1092,

(2) Each taxpayer would have a one time election to include all stock, debt, index, currency, and commodity options traded on an exchange or a board of trade within the present mark to market and 60/40 rules of section 1256. Thus, there would be an election to treat options as regulated futures contracts ("RFCs"),

(3) Section 1234 would be amended to clarify that for those taxpayers who do not elect to have their options treated as RFCs, transactions in stock index options and commodity options produce short-term capital gain or loss, and

(4) The "offsetting position" rules of section 1092 would be amended to clarify that such rules do not apply to certain option writing transactions which have legitimate economic purposes, such as non-deep in the money covered calls.

The specific statutory changes needed to effectuate this proposal are set out in Appendices A through E to the attached memorandum.

Although the straddle provisions of the Economic Recovery Tax Act of 1981 ("ERTA") have brought most of the abusive straddle transactions to a halt, as indicated in a recent statement of Robert G. Woodward, Acting Tax Legislative Counsel, there continue to be tax straddle opportunities through the use of stock options. This proposal would shut down those continuing opportunities. Further, one of the collateral effects of the straddle provisions of ERTA was to create different tax regimes for options and futures. This significant discontinuity in the tax treatment of essentially comparable products tends to decrease economic efficiency by distorting investment decisions. This proposal would eliminate that discontinuity. Finally, there continue to be uncertainties in the tax treatment of cash settlement options and commodity options. This proposal would resolve those uncertainties.

We will be meeting today with Mr. Richard L. Reinhold of your staff to have a preliminary discussion of this proposal, and on Thursday, August 25, 1983 we will be meeting with your Deputy, Ronald A. Pearlman, for further discussions. We would be pleased to provide your office with any additional memoranda that might be needed in evaluating this proposal, and we would hope to work with your office in the implementation of this proposal.

Finally, you will recall that during the consideration of the straddle provisions of ERTA, you met with Mr. Walter E. Auch, the Chairman of the CBOE, concerning the issue of whether stock options should be included within the straddle rules. Mr. Auch followed up that meeting with a letter to you in which he gave you his personal commitment that if stock options were excluded from the straddle provisions of ERTA and if abuses developed, the CBOE would work with Treasury to bring those abuses to an end. This proposal is in response both to that commitment and to the desire of the CBOE to have its products taxed the same as essentially comparable futures products. In other words, the CBOE wants both an end to any abuses that may have developed and a "level playing field." The CBOE is certain that both these goals are sound tax policy.

Mr. Auch has asked me to express to you his willingness to discuss with you personally any questions you might have concerning this proposal.

I look forward to hearing from you.

Sincerely,

Samuel C Thompson Jr

Samuel C. Thompson, Jr.

Enclosure
cc: Ronald A. Pearlman
Richard L. Reinhold

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MEMORANDUM FOR THE UNITED STATES DEPARTMENT OF THE TREASURY

LEGISLATIVE PROPOSAL FOR TAXATION OF LISTED OPTION CONTRACTS

Submitted on behalf of the
Chicago Board Options Exchange, Inc.

Samuel C. Thompson, Jr. and
Paul R. Wysocki
Counsel for the Chicago
Board Options Exchange, Inc.

August 15, 1983

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SUMMARY OF LEGISLATIVE PROPOSAL

I. PURPOSES

The principal purposes of this legislative proposal are to provide a consistent federal income tax regime for the taxation of options and futures and to eliminate the use of stock option straddles for the deferral of short-term capital gain by investors and the deferral of ordinary income by limited partners of a syndicate. This legislative proposal would (1) include all stock, debt, index, currency, and commodity options traded on an exchange or a board of trade within the present mark to market and 60/40 rules of section 1256 governing futures, provided a taxpayer files a one time election to have such treatment, (2) include stock options (and stock to the extent offset by options) within the present loss deferral rules of section 1092, and (3) clarify the tax treatment of various new investment products. The amendments to section 1092 would also clarify that the loss deferral rules do not apply to certain option writing transactions which do not substantially diminish an investor's risk of loss with respect to the underlying stock or security.

The following outline summarizes the proposed federal income tax treatment for both non-electing and electing taxpayers.

II. TAX TREATMENT OF TAXPAYER WHO DOES NOT FILE ELECTION

A. Gain or Loss

An investor would recognize short-term capital gain or loss on his stock, debt, currency, index, and commodity option transactions, and an options dealer would continue to recognize ordinary income or loss on his option transactions in his dealer account. An options dealer who trades options in an investment account would be treated the same as an investor who does not file an election (i.e., short-term capital gain or loss).

B. Loss Deferral Rules

Taxpayers would be subject to the loss deferral rules of section 1092 on their offsetting positions, including spreads consisting of stock options and deep in the money covered calls.

C. Hedging Exemption

An options dealer could utilize the hedging exemption to the loss deferral rules but only if such hedging transaction were entered into in the normal course of business and were not for the purpose of tax avoidance.

III. TAX TREATMENT OF TAXPAYER WHO FILES ELECTION

A. Pure Option Transactions: Marked to Market

A taxpayer who enters into naked option positions or into option spreads would be marked to market on the option positions at year end and would recognize any gain or loss on the marked or closed positions as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. Accordingly, options would be treated the same as regulated futures contracts ("RFC-Options").

B. Straddle Transactions Where Only One Leg Is An RFC-Option

1. In General

The tax consequences of a straddle where one but not all positions making up the straddle are RFC-Options ("RFC/Non-RFC straddle") would depend first on whether the taxpayer is a dealer in the underlying stock or security for purposes of federal income taxation.

2. Definition of Dealer

Under current federal income tax law, an options dealer may be a dealer with respect to his stock and security transactions where such transactions are in the normal course of the options dealer's trade or business of granting and acquiring options. If an options dealer elects RFC treatment, the proposal would clarify that he would no longer be a dealer in options and would no longer be considered a dealer in the underlying stock or security solely by reason of his trading activities in RFC-Options.

3. Taxpayer Who Is a Dealer in Underlying Stock or Security -- Application of the Hedging Exemption

If a taxpayer, who is a dealer in an underlying stock or security, enters into an RFC-Option transaction to reduce the risk of loss from holding the underlying stock or security, the taxpayer could utilize the hedging exemption to the loss deferral rules and to the mark to market rules. If the hedging exemption applied to such a straddle transaction, the RFC-Option position would not be marked to market and any gain or loss would be ordinary income or loss when realized.

4. Taxpayer Who Is Not a Dealer in Underlying Stock or Security

a. Both Mark to Market and Loss Deferral Rules Apply to an RFC/Non-RFC Straddle

An RFC/Non-RFC straddle would be subject to the loss deferral rules and the RFC-Option leg would be subject to the mark to market rules, unless the taxpayer made the "mixed straddle" election discussed below.

b. "Mixed Straddle" Election

A taxpayer could make a one-time "mixed straddle" election in which case the mark to market rule would not apply to the RFC-Option leg and both positions would only be subject to the loss deferral rules. The "mixed straddle" election would only apply if the taxpayer identified the straddle before the close of the day when the RFC-Option position was acquired. Any gain or loss would be short-term capital gain or loss.

c. No "Mixed Straddle" Election

If a taxpayer does not make the "mixed straddle" election (or failed to identify the RFC/Non-RFC straddle), then the RFC-Option position would be marked to market at year end. If the RFC-Option position had appreciated in value the gain would be recognized; however, if the RFC-Option position had depreciated in value the loss would be deferred under the loss deferral rules.

IV. IMPLEMENTATION

A discussion of the present law of the taxation of options is set out below at pages 9 to 33 and a discussion of the present tax treatment of futures is set out at pages 34 to 46. Those readers who are familiar with the present tax treatment of options and futures might proceed to the discussion of the REASONS FOR CHANGE which is set out at pages 46 to 54 and the EXPLANATION OF PROVISIONS which is discussed at pages 55 to 76.

As will be seen in the explanation, this legislative proposal would be implemented within the context of the current statutory provisions governing options and futures. The two principal amendments are those which (1) bring stock options (and stock to a limited extent) into the loss deferral rules of section 1092, and (2) give the taxpayer an election to have his options treated as "regulated futures contracts" within the meaning of the current section 1256(b).

Appendices A-E set out in full the particular sections of the Internal Revenue Code that would be amended to implement this legislative proposal. The additional language is underlined and the deleted language is lined through. The following is a brief description of the amendments, together with references to the specific Code section changes and to the pages of this memorandum that discuss the particular changes.

Section 1092 (Exhibit A) is amended to:	New Section	Discussion
1. Make stock options and stock (to the extent offset by options) "positions" in "personal property" and therefore within section 1092.	§1092(d)(1)&(2)	page 56 to 58

	New Section	Discussion
2. Exclude non-deep in the money covered call transactions in stock and debt (and similar transactions involving written puts) from the offsetting position rule of section 1092(c)(2).	§1092(c)(2)(D)	page 58 to 62

Section 1256 (Exhibit B) is amended to:

	New Section	Discussion
1. Define "listed option contract."	§1256(h)	page 66 to 67
2. Set forth an election procedure for listed option contracts.	§1256(i)(1)-(3)	page 65 to 66
3. Clarify that an election under section 1256(i) will not affect the determination of whether the taxpayer is exempt from the wash sale rules of section 1091.	§1256(i)(4)	page 70 to 71
4. Treat listed option contracts as RFCs provided the taxpayer has made the election in section 1256(i).	§1256(b)	page 65 to 67
5. Provide that the gain or loss from the trading (whether or not such trading is in the ordinary course of the taxpayer's business) of RFC's (including listed option contracts that are treated as RFCs) shall be considered as capital gain and loss, except to the extent the RFC is held for the purposes of hedging the underlying property.	§1256(f)(2)	page 67 to 71
6. Make it clear that in no case shall property that underlies an RFC be considered as ordinary income or loss property solely by reason of the fact that the taxpayer trades RFCs.	§1256(f)(2)	page 70

	New Section	Discussion
7. Make it clear that the gain or loss with respect to an RFC option is segregated from the gain or loss from the underlying property.	§1256(c)(1) & §1256(c)(2)	page 71
Section 1234 (Exhibit C) is amended to:		
Treat the gain or loss on cash settlement options and commodity options held by a taxpayer, who does not make the section 1256(i) election, as short-term capital gain or loss, except to the extent such options are traded in the ordinary course of the taxpayer's trade or business.	§1234(c)	page 63 to 64
Section 1236 (Exhibit D) is amended to:		
Make it clear that that section 1236 does not apply to a taxpayer who has made the election in section 1256(i).	§1236(f)	page 68
Section 263(g) (Exhibit E) is amended to:		
Provide that if stock is subject to the straddle rules, any dividends with respect to such stock will be taken into account in determining the amount of carrying charges that are required to be capitalized.	§263(g)(2)(B)	page 64 to 65
In the case of "unidentified mixed straddles," the regulations under section 1092(b) would:		
(1) Prevent conversion of unrelated long-term capital gain or short-term capital gain, and		
(2) Allow a taxpayer to receive 60/40 treatment to the extent the gain from the RFC leg exceeds the realized loss from the non-RFC leg.	Regulations under §1092(b)	page 73 to 75

PRESENT LAW

I. TAXATION OF OPTIONS

A. Introduction

Under present law, the federal income tax treatment of exchange-traded options[1] depends on the type of option traded and the status of the taxpayer trading the options. Presently, GNMA options, Treasury Note options and Treasury Bond options (such options are hereinafter referred to as "debt options"), cash settlement index options (such options are hereinafter referred to as "cash settlement options"), stock options, and currency options are traded on one or more of the domestic security exchanges. Options where the underlying property is a regulated futures contract are currently traded on domestic boards of trade (such options are hereinafter referred to as "commodity options"). The following discussion examines the present (1) tax treatment of stock options, debt options and currency options where such options are traded by investors or dealers, (2) tax treatment of commodity options and cash settlement options, and (3) application of the loss deferral rules of section 1092[2] to transactions in options.

---

[1] Currently, options are traded on the following four domestic stock and option exchanges: the American Stock Exchange, Inc., the Chicago Board Options Exchange, Inc., the Pacific Stock Exchange, Inc., and, the Philadelphia Stock Exchange, Inc.

B.[3] Investor-Traded Stock Options, Debt Options and Currency Options[4]

The law governing the taxation of option transactions of investors is set forth principally in two revenue rulings both of which apply only to stock option transactions.[5] There are no differences between the mechanics of transactions in stock options, debt options and currency options that mandate differing tax treatment and, therefore, the rules set forth below for stock options should apply equally to debt options and currency options.

---

[2] Section 1092 of the Internal Revenue Code of 1954, as amended (the "Code"). Unless otherwise specified, all section references contained herein are to sections of the Code and the regulations ("Reg.___") promulgated thereunder.

[3] The discussion in this section is based on a memorandum entitled The Federal Income Tax Treatment of Options on Debt Securities and Physical Commodities and Options on Commodity Futures Contracts, submitted to the Treasury Department on behalf of the American Stock Exchange, Inc., the Chicago Board Options Exchange, Inc. and the Philadelphia Stock Exchange, Inc. (August 19, 1982). *See* note 28 *infra*.

[4] For purposes of this section, it is assumed that the underlying property would be a capital asset in the hands of the holder and, with respect to the writer, the option is not granted in the ordinary course of the taxpayer's trade or business of writing options.

[5] *See* Rev. Rul. 78-182, 1978-1 C.B. 265 and Rev. Rul. 58-234, 1958-1 C.B. 279.

1. Holder of a Call Option

a. Acquisition

The payment of the option premium to the writer of a call option results in no income tax consequences to the holder at the time of execution of the option. The option transaction is considered an open transaction, and no gain or loss is recognized until exercise or lapse of the option, or sale of the holder's rights through a closing transaction executed on the exchange.

b. Closing Sale Transaction

If a holder sells his rights under the option prior to lapse through a closing sale transaction,[6] any resulting gain or loss is considered gain or loss from the sale or exchange of property which has the same character as the underlying option property.[7] The period the option is held by the holder prior to the closing transaction determines whether the capital gain or loss is short-term or long-term.[8]

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[6] A holder of a call option completes a closing sale transaction by writing a call option with the same strike price and expiration date.

[7] Section 1234(a)(1).

[8] Reg. § 1.1234-1(a)(1). Presently, no exchange-traded options are granted with a term in excess of nine months. Accordingly, unless the required holding period for long-term treatment is reduced to less than nine months, all capital gains and losses with respect to exchange-traded options are short-term.

c. Lapse

If a holder allows the call option to lapse, the holder is deemed to have sold or exchanged the call option on the day it expires.[9] Therefore, depending on the holding period of the option, the loss resulting from the payment of the premium is recognized as a short-term or long-term capital loss on the expiration date of the option.

d. Exercise[10]

If a holder exercises a call option, the holder purchases the underlying stock or debt instrument at the strike price of the option. The basis of the property acquired by the holder for purposes of determining gain or loss on the subsequent disposition of the stock or debt instrument equals the cost of the premium plus the strike price of the call option. Any gain or loss in the underlying property which accrued during the period the option was held is not recognized by the holder at the time of exercise.[11] The holder may not include the holding period of the option in the holding period of the property acquired.[12]

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[9] Sections 1234(a)(1) and 1234(a)(2).

[10] Once an option trade is cleared through the clearing organization, the clearing organization substitutes itself with respect to the option as the holder to the writer and the writer to the holder. When a holder exercises his option against the clearing organization, the clearing organization exercises its option against an option writer.

2. Writer of a Call Option

a. Grant of a Call

Since an option is considered to be an open transaction, gain attributable to the option premium is not recognized until the option lapses, is exercised, or until the obligation of the writer with respect to the option is terminated by a closing purchase transaction.[13]

b. Closing Purchase Transaction

Any gain or loss resulting from a closing transaction which terminates the writer's obligations under the option is treated as short-term capital gain or loss.[14]

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[11] See, e.g., Helvering v. San Joaquin Fruit & Investment Co., 297 U.S. 496 (1936).

[12] See Milliken v. Comm'r., 196 F.2d 135 (2d Cir.), cert. denied, 344 U.S. 884 (1952); Molbreak v. Comm'r., 61 T.C. 382 (1973), aff'd, 509 F.2d 616 (7th Cir. 1975); Wyman v. Comm'r., 33 T.C. 622 (1959).

[13] See Virginia Iron, Coal & Coke Co. v. Comm'r., 37 B.T.A. 195, aff'd, 99 F.2d 919 (4th Cir. 1938), cert. denied, 307 U.S. 630 (1939).

[14] Section 1234(b)(1).

c. Lapse

If the option is allowed to lapse, gain attributable to the option premium is considered short-term capital gain to the writer.[15]

d. Exercise

Upon exercise of a call option, a writer is obligated to sell the underlying stock or debt instrument to the holder. The premium received is considered to constitute part of the purchase price of the property sold. Therefore, the total amount realized for the underlying property for purposes of determining gain or loss on the sale by the writer equals the premium plus the strike price of the option. The holding period of the writer with respect to gain or loss on the sale depends upon the holding period of the underlying property.

3. Holder of a Put Option

a. Acquisition

As in the case of a holder of a call, no tax consequences result to the holder of a put upon the payment of the option premium.[16] The cost of the premium may not be deducted at the time paid, nor designated as part of the purchase price of any particular property.

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[15] Id.

[16] The acquisition of a put, however, may constitute a short sale for purposes of section 1233(b) when property substantially identical to the option property is held by the writer. The exercise, sale, or expiration of the put is a closing of the short sale. See Rev. Rul. 78-182, 1978-1 C.B. 265.

b. Closing Sale Transaction

If the holder of a put enters into a closing sale transaction during the term of the option, the holder recognizes any gain or loss on the closing transaction as capital gain or loss.[17]

c. Lapse

If the holder allows the option to lapse, the expiration is treated as a sale or exchange of a capital asset on the expiration date.[18] The resultant loss, equal to the premium paid, is a capital loss.[19]

d. Exercise

Upon exercise of the put option, the holder sells the underlying stock or debt instrument to the writer at the strike price set forth in the option. The amount of the premium previously paid for the option is treated as a reduction of the amount realized by the holder on the sale of the underlying property for purposes of determining gain or loss with respect to the sale. Subject to the short sale rules, the resultant gain or loss on the sale is either short-term[20/] or long-term, depending upon the length of time the holder has held the property sold pursuant to the option.

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[17] Subject to the possible applicability of the short sale rules, the period the option is held determines whether such gain or loss is short-term or long-term.

[18] Sections 1234(a)(1) and 1234(a)(2).

[19] Subject to the possible applicability of the short sale rules, the holding period of the option determines whether such loss is short-term or long-term.

4. Writer of a Put Option

a. Grant of a Put

As with the receipt of a premium by a writer of a call, the writer of a put does not include the amount of the premium in income at the time of receipt. The amount of the premium is realized when the option lapses, is exercised, or when the writer's obligation with respect to the option is terminated through a closing purchase transaction.

b. Closing Purchase Transaction

If the writer terminates his obligations under the option prior to exercise or lapse by entering into a closing transaction, the capital gain or loss is considered short-term.[21/]

c. Lapse

If the option is allowed to lapse, the amount of the premium is treated as gain from the sale or exchange of a capital asset and recognized as short-term capital gain to the writer.[22/]

[20/] See note 16 supra.

[21/] Section 1234(b)(1).

[22/] Id.

d. Exercise

Upon exercise of the put, the writer purchases the underlying stock or debt instrument from the holder at the strike price of the option. The amount of the premium previously received by the writer is considered to constitute a reduction of the purchase price of the underlying property for purposes of determining gain or loss on a subsequent sale of the property. The writer may not include the holding period of the option in determining the holding period of the underlying property.[23]

C. Dealer-Traded Stock Options, Debt Options and Currency Options[24]

Any gain or loss from option transactions in the ordinary course of a taxpayer's trade or business is ordinary income or loss.[25] In its discussion of the 1976 amendments to section 1234(b), the Joint Committee's General Explanation of the Tax Reform Act of 1976 discusses this ordinary income or loss treatment for a dealer who writes an option:

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[23] *See, e.g.*, *Milliken v. Comm'r*, 196 F.2d 135 (2d Cir.) *cert. denied*, 344 U.S. 884 (1952).

[24] Under applicable case law, gain or loss associated with trading activities in options is ordinary income or loss to the extent such trading activities are for the purpose of hedging inventory in the underlying property. *Cf.* *Corn Products Refining Co. v. Comm'r*, 350 U.S. 46 (1955).

[25] Under present law, the trading activities of an options dealer in an investment account are treated as investor-trading activities. *See* General Explanation of the Tax Reform Act of 1976, H.R. Rep. No. 10612, 94th Cong., 1st Sess. 673, *reprinted in* 1976-3 (Vol. 2) C.B. 687.

> Gain or loss from transactions in options written in the ordinary course of the taxpayer's trade or business would continue to be treated as ordinary income or loss. [See Section 1234(b)(3).] This rule is consistent with the provisions of the tax law generally concerning the tax treatment of broker-dealers in stock or securities. It is possible, of course, that some taxpayers may write certain options in the ordinary course of their trade or business, and may write other options in connection with their investment activities. In such cases, the new rules would apply to options written in connection with the taxpayer's investment activities. The determination as to whether an option is written in the ordinary course of a taxpayer's trade or business, or as an investment, is to be determined under principles similar to those which apply the tax law in the case of a broker-dealer in securities. Generally, it is anticipated that persons who are treated as writers of options in the ordinary course of their trade or business will be those who "make a market" with respect to a particular option.[26]

Under section 1234(a)(3) this same ordinary income or loss treatment applies also to options acquired by an options dealer in the course of his trade or business. In interpreting section 1234(a)(3), Reg. § 1.1234-1(d) says that "[a]ny gain or loss realized by a dealer in options from the sale or exchange of an option to buy or sell property is ordinary income or loss...."

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[26] General Explanation of the Tax Reform Act of 1976, H.R. Rep. No. 10612, 94th Cong., 1st Sess. 673, reprinted in 1976-3 (Vol. 2) C.B. 687. See Section 1234(b)(3) and Reg. § 1.1234-3(c).

Gain or loss with respect to dealer-traded options is recognized under the rules discussed above in connection with investor-traded options or as prescribed in the inventory accounting provisions of the Code.

Under present law, an options dealer also recognizes ordinary income or loss with respect to underlying property which he purchases to sell upon exercise of options previously written, since such property constitutes "a necessary part of [his] stock in trade when used to satisfy the exercise of an option."[27] Reg. § 1.1234-1(d) also provides that "[a] dealer in options . . . is considered a dealer in the property subject to the option."

D. Taxation of Commodity Options and Cash Settlement Options

1. Commodity Options

Under present law, the federal income tax treatment of commodity options is unclear. In memoranda filed with The United States Department of the Treasury, three security exchanges have presented one view of the current taxation of commodity options and a board of trade has presented another.[28] Neither the Treasury Department nor the Internal Revenue Service has taken a position on the issue.

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[27] See Technical Advice Memorandum 8141035 (June 30, 1981).

[28] See The Federal Income Tax Treatment of Options on Debt Securities and Physical Commodities and Options on Commodity Futures Contracts, submitted on behalf of the

(Footnote continued on next page)

In general, the security exchanges have taken the position that under current federal income tax laws:

(a) A commodity option is not a regulated futures contract under section 1256(b);

(b) Gain or loss upon disposition of a commodity option should not be treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss under section 1256(a)(3); and

(c) Gain or loss attributable to a commodity option cannot be converted into 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss under section 1256(a)(3) on exercise of the commodity option.

With respect to the latter issue, the security exchanges maintain that on exercise of a commodity option the exercise constitutes a recognition event for purposes of federal income taxation or, in the alternative, any gain or loss with respect to the option must be segregated from the gain or loss with respect to the underlying regulated futures contract.

(Footnote continued from previous page)
American Stock Exchange, Inc., the Chicago Board Options Exchange, Inc. and the Philadelphia Stock Exchange, Inc. (August 19, 1982) and The Tax Treatment of Options on Commodity Futures Contracts, submitted on behalf of the Coffee, Sugar and Cocoa Exchange, Inc. (September 29, 1982).

In contrast to the position of the security exchanges, the Coffee, Sugar and Cocoa Exchange, Inc. has taken the position that commodity options should be taxed according to the following rules:

(a) All gain or loss taken into account by grantors and holders of commodity options is 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss without regard to the actual holding period of the commodity option;

(b) Grantors of commodity options recognize gain or loss on termination of their obligation under the option by offsetting, by taking or making delivery, or otherwise, and on positions open at the end of the tax year. Thus, as to grantors, short commodity options are regulated futures contracts and are marked to market; and

(c) Holders of commodity options are not, however, subject to the mark to market rule. Holders do not recognize gain or loss on the exercise of the commodity option and on entry into the regulated futures contract, and the premium paid for the commodity option is treated as an adjustment when gain or loss on the regulated futures contract is recognized. Gain or loss is taken into account by holders on lapse of the commodity options or on their termination by offset.

2. Cash Settlement Options

Section 1234, which governs the tax treatment of options in general, provides rules in the case of a purchaser of "an option to buy or sell property"[29] and rules in the case of a grantor of "an option in property."[30] It is not clear whether the term "property" as used in section 1234 includes cash. Thus, the tax treatment of cash settlement options is not clear under present law.[31]

Cash settlement options are traded on exchanges and the mechanics of the transactions in these options is essentially the same as the mechanics of transactions in stock options, except that cash is received on exercise. As pointed out below, this legislative proposal would amend section 1234 to clarify that an investor has capital gain or loss with respect to transactions in cash settlement options and that a dealer in such options is governed by the same rules that apply to dealers in stock options or debt options.

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[29] Section 1234(a)(1).

[30] Section 1234(b)(1).

[31] *See* the letter and supporting memorandum regarding the tax treatment of New York Stock Exchange Index Options from Robert K. Sharp of Milbank Tweed Hadley & McCloy to Thomas J. Gallagher, Esq. of the Treasury Department (March 11, 1982).

E. Application of Section 1092

1. ~~Intro~~duction

Under present law, options (other than certain stock options) are positions in personal property[32] and are subject to the loss deferral rules contained in section 1092, to the extent such options are part of a straddle.

2. Straddle Defined

Section 1092(c)(1) defines a straddle as "offsetting positions with respect to personal property." Personal property is defined in section 1092(d)(1) as "any personal property (other than stock) of a type which is actively traded." Thus, personal property includes, for example, debt instruments and various currencies. Section 1092(d)(2)(A) defines a position as "an interest (including a futures or forward contract or option) in personal property." Thus, for example, a forward contract on silver or an option on debt instruments, such as Treasury Bills or GNMA certificates, is a position in personal property. Although a futures contract is a position for purposes of section 1092(d)(2)(A), regulated futures contracts in general are subject to the mark to market rule of section 1256 and thus are not subject to section 1092.[33]

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[32] Section 1092(d)(2).

Generally, section 1092(c)(2) provides that a taxpayer holds offsetting positions with respect to personal property "if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions with respect to personal property (whether or not of the same kind)." The Senate Finance Committee Report to the Economic Recovery Tax Act of 1981 ("ERTA") elaborates on the substantial diminution concept by noting that although the concept is not "narrowly defined," a "mere diversification of positions" would not substantially reduce risk as long as the positions are not "balanced."[34] Section 1092 also sets forth certain circumstances in which positions are presumed to be offsetting.[35]

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[33] Section 1256(a)(4). As explained more fully below, regulated futures contracts that are part of mixed straddles (*i.e.*, a straddle consisting of a regulated futures contract and a non-regulated futures contract) are subject to section 1092.

[34] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 150.

[35] Section 1092(c)(3)(A). Section 1092(d)(3) contains an attribution rule which treats positions held by a "related person" or a "flowthrough entity" of which the taxpayer is an owner as being positions held by the taxpayer. A "related person" is defined to mean the taxpayer's spouse or a corporation which files a consolidated return with the taxpayer under section 1501. "Flowthrough entities" include trusts, partnerships and S corporations.

3. The Loss Deferral Rule

The general loss deferral rule of section 1092(a) limits the recognition of loss incurred on the disposition of one leg of a straddle to an amount equal to the difference between the loss from the disposed leg and any unrecognized gain on the other leg as of the end of the taxable year.[36] Therefore, where the amount of the loss is equal to or less than the unrecognized gain, the loss is not allowed. For example, if a taxpayer enters into a straddle consisting of a long debt option and a short debt option and later disposes of the short option at a loss of $100, section 1092(a) limits recognition of that $100 loss to the excess of the loss over the unrecognized gain in the long debt option. If the unrecognized gain were $90, the taxpayer could claim a $10 loss; if the unrecognized gain were $100, the taxpayer is not permitted to claim a loss.

This provision applies where the gain position or positions were offsetting positions with respect to the position or positions from which the loss arose.[37] Unrecognized gain in the case of any position held by a taxpayer as of the close of the taxable year is defined as the "amount of gain which would be taken into account with respect to such position if such position were sold on the last business day of such taxable year at its fair market value."[38/] In the case of "any position with respect to which, as of the close of the taxable year, gain has been realized but not recognized," unrecognized gain means "the amount of gain so realized."[39/]

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[36] Section 1092(a)(1).

[37] *Id.*

Any loss that is disallowed for a tax year is treated as though sustained in the succeeding tax year unless again disallowed under the general loss deferral rule of section 1092(a)(1).[40/] The Senate Finance Committee Report explains:

> Deferred losses are recognized in the first taxable year in which there is no unrealized appreciation in offsetting positions acquired before the disposition of the loss position. If there is more than one position with unrealized gain which was acquired prior to the loss disposition, which offsets the loss position and which does not belong to an identified straddle, the bill authorizes the Secretary of the Treasury to prescribe regulations for allocating loss among the unrealized gain in such positions and for allocating unrealized gain among loss positions.[41/]

[38/] Section 1092(a)(3)(A).

[39/] Section 1092(a)(3)(A)(ii). Section 1092(a)(3)(B) provides that at the end of the taxable year, each taxpayer is required to disclose all of his open positions that show a gain, and the amount of each unrecognized gain.

[40/] Section 1092(a)(1)(B).

[41/] S. Rep. No. 144, 97th Cong., 1st Sess. 147.

4. Identified Straddles

A taxpayer can choose not to have the loss deferral rules apply to certain straddles if he designates them as identified straddles.[42/] In order for a straddle to qualify as an identified straddle, it must meet the following four conditions: (1) it must be clearly identified as such in the taxpayer's records before the close of the day on which it was acquired; (2) all of the original positions which comprise it must be acquired on the same day; (3) all of the positions must be disposed of on the same day during the taxable year or must all still be open at the end of the taxable year; and (4) it cannot be part of a larger straddle.[43/] Any loss with respect to an identified straddle is treated as "sustained not earlier than the day on which all the positions making up the straddle are disposed of."[44/] If a taxpayer initially designates a straddle as an identified straddle and disposes of the loss leg while retaining the gain leg, the taxpayer must disclose the unrecognized gain and the loss is allowed only to the extent it exceeds such gain.

[42/] Section 1092(a)(2)(A)(i).

[43/] Section 1092(a)(2)(B).

[44/] Section 1092(a)(2)(A)(ii).

5. Wash Sale and Short Sale Rules

Section 1092(b) authorizes the Secretary to promulgate regulations that will apply rules similar to the wash sale rule of section 1091 and the short sale rules of section 1233(b) and (d) to gain or loss with respect to any position of a straddle. Section 1091(a) prohibits a loss deduction resulting from the disposition of stock or securities if the taxpayer acquires (or enters into a contract or option to acquire) stock or securities substantially identical to those disposed of within thirty days before or after the loss sale. A basis adjustment is made to the newly acquired stock or security in order to reflect properly the disallowed loss.[45/] Section 1092(b) substantially expands the coverage of the wash sale rule in two respects. First, the wash sale rule now applies to interests in "personal property" as defined in section 1092(d)(1) and not only to stock and securities. Second, since section 1092 applies to "straddles," the concept of "offsetting position" is substituted for the concept of "substantially identical property."

Section 1092(b) also authorizes the Secretary to promulgate regulations to extend the short sale rules of section 1233(b) and (d) to straddles and thereby replaces the "substantially identical" concept of section 1233 with

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[45/] Section 1091(d).

the "offsetting position" concept of section 1092. A short sale is a sale of property where the seller does not own the property sold. In the absence of section 1233, taxpayers could use short sales to "lock in" the gain on a capital asset before the long-term capital gain holding period had run, thereby enabling them to obtain preferential tax treatment in situations where they were not exposed to the risk of holding the property for the requisite long-term period.

Section 1233(b) contains two rules designed to prevent conversion of short-term capital gain into long-term.[46] The two rules under section 1233(b) apply when the gain or loss on a short sale will produce capital gain or loss and the taxpayer either (a) holds property on the date of the short sale which is "substantially identical" to the property used to close the short sale and which has not been held for the long-term holding period as of the date of the short sale, or (b) acquires "substantially identical property" after the short sale and before the closing.[47] Any gain realized upon the closing of such a short sale is treated as short-term capital gain and the holding period of the "substantially identical property" begins on the date of closing if the holding period was terminated on the date of the short sale. Section 1233(d) contains a third rule designed to prevent the conversion of long-term capital loss into short-term capital loss. This rule applies whenever the taxpayer holds property on the date of the short sale which has been held for longer than the long-term holding period and which is substantially identical to the property used to close the short sale.[48/] Any loss realized upon the closing of such a short sale is treated as long-term loss, notwithstanding the fact that the property used to close the short sale has been held for less than the long-term holding period.[49/]

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[46] A put may also be a short sale for purposes of these two rules.

[47] Id.

6. Special Exemption for Straddles in Stock Options

Section 1092(d)(2)(B) provides a special rule for stock options by expanding the definition of a position to include stock options which are part of a straddle and are options to buy or sell stock that is actively traded. However, the loss deferral rules of section 1092 do not apply to any stock option which:

[48/] Section 1233(d).

[49/] *Id*.

> (i) is traded on a domestic exchange or on a similar foreign exchange designated by the Secretary, and
> (ii) is of a type with respect to which the maximum period during which such option may be exercised is less than the minimum period for which a capital asset must be held for gain to be treated as long-term capital gain under section 1222(3).[50]

Thus, section 1092 does not apply to offsetting positions in exchange-traded stock options which have a maximum holding period of less than twelve months. Since all domestic exchange-traded stock options have a maximum term of nine months, straddles in such options are presently exempt from section 1092.[51]

Section 1092(d)(1) excludes stock from the definition of personal property. Accordingly, section 1092 does not apply to a stock and stock option straddle transaction.

7. Cash and Carry Transactions

Section 263(g) disallows deductions for "interest and carrying charges properly allocable to personal property which is part of a straddle."[52] The disallowed deductions are capitalized[53] and the increase in basis acts to lower any capital gain realized on the sale of the property rather than to offset ordinary income. The capitalization requirement as currently defined applies to interest on indebtedness incurred to purchase the straddle property and all other costs (including charges for the temporary use of borrowed property) incurred in insuring, storing, transporting or carrying the property.[54] The amount of the charges to be capitalized is reduced by any interest income and acquisition discount from the property which is includible in the taxpayer's gross income for the year.[55] This capitalization requirement does not apply to hedging transactions.[56] Thus, the expenses of securities dealers for financing their inventory and trading accounts which generate ordinary income or loss are deductible.[57]

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[50] Section 1092(d)(2)(B).

[51] Twelve months is the currently required holding period for long-term capital gains. See Section 1222(3).

[52] Section 263(g)(1).

[53] Id.

8. The Hedging Exemption

The loss deferral rules for straddles do not apply to hedging transactions.[58] There are three principal requirements that must be met for the hedging exemption to apply.[59] First, the hedging transaction must be entered into in the normal course of the taxpayer's business, primarily to reduce the risk of price fluctuations.[60] Second, the gain or loss on the transaction must be ordinary.[61] Third, the taxpayer must clearly identify the transaction as a hedging transaction before the close of the day on which the taxpayer entered into the transaction.[62] The Senate Finance Committee Report to ERTA provides for blanket indentification for certain classes of transactions as hedging transactions without a requirement of matching up the hedged property with the hedging property. The report states:

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[54] Section 263(g)(2)(A).

[55] Section 263(g)(2)(B).

[56] Section 263(g)(3).

[57] See S. Rep. No. 144, 97th Cong., 1st Sess. 154.

[58] Section 1092(e).

> Taxpayers, such as banks or securities dealers, who may conduct thousands of hedging transactions to hedge property held or to be held in their accounts, may identify such accounts as hedged accounts without marking individual items as hedges or hedged property, provided such accounts deal only with ordinary income (or loss) items.[63]

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[59] Section 1256(e)(2).

[60] Section 1256(e)(2)(A).

[61] Section 1256(e)(2)(B).

[62] Section 1256(e)(2)(C).

[63] S. Rep. No. 144, 97th Cong., 1st Sess. 151, 159.

II. TAXATION OF REGULATED FUTURES CONTRACTS

A. Introduction

ERTA radically changed prior law by requiring that all open regulated futures contracts ("RFCs") be marked to market at year end.[64] The gains and losses from both open and closed RFCs are treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss for a maximum tax rate of thirty-two percent.[65]

B. RFC Defined

As amended by the Technical Corrections Act of 1982,[66] the term RFC is defined as a contract:

> (1) with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marketing to market; and
> (2) which is traded on or subject to the rules of a domestic board of trade designated as a contract market by the Commodities Futures Trading Commission ["CFTC"] or of any board of trade or exchange which the Secretary determines has rules adequate to carry out the purposes of this section.

Such term includes any foreign currency contract.[67]

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[64] *See* Section 1256.

[65] Section 1256(a)(3).

[66] *See* Pub. L. No. 97-448, § 105(c)(5), 96 Stat. 2365, 2385 (1983).

[67] Section 1256(b).

The Technical Corrections Act of 1982 amended section 1256(b) to eliminate the former requirement of delivery of personal property or of an interest in such property.[68/] The purpose of this change was to bring cash settlement futures contracts within the definition of an RFC.[69/] Cash settlement futures contracts do not provide for the delivery of personal property, such as a corn futures contract, but call for cash settlement only. Accordingly, the Technical Corrections Act overrides the position taken by the staff of the Joint Committee on Taxation to the effect that cash settlement contracts were not RFCs because cash was not "personal property" for purposes of section 1092.[70/]

[68/] See Pub. L. No. 97-448, § 105(c)(5), 96 Stat. 2365, 2385; Section 1256(b). Prior to the Technical Corrections Act, section 1256(b)(1) required "delivery of personal property (as defined in section 1092(d)(1)) or an interest in such property." Pub. L. No. 97-34, § 503, 95 Stat. 172, 327-30 (1981). Under section 1092(d)(1), personal property is defined as "any personal property (other than stock) of a type which is actively traded."

[69/] See Conference Report on H.R. 6056, Technical Corrections Act of 1982, 97th Cong., 2d Sess., 128 Cong. Rec. H10696, H10702 (daily ed. Dec. 21, 1982) [hereinafter cited as "Conference Report"].

[70/] See General Explanation of the Economic Recovery Tax Act of 1981, 97th Cong., 1st Sess. 289 (J. Comm. Print 1981) (prepared by the Staff of the Joint Committee on Taxation) [hereinafter cited as "General Explanation].

The Technical Corrections Act added foreign currency contracts to the definition of an RFC.[71/] A "foreign currency contract" is defined in section 1256(g) as a contract requiring delivery of a foreign currency in which positions are also traded through RFCs and which is traded in the interbank market.[72/] The Technical Corrections Act House Report describes such contracts, also known as bank forward contracts, as follows:

> Trading in foreign currency for future delivery is conducted through regulated futures contracts, and is also conducted through contracts negotiated with any one of a number of commercial banks which comprise an informal market for such trading (bank forward contracts). Bank forward contracts differ from regulated futures contracts in that they are private contracts in which the parties remain entitled to performance from each other. They further differ from regulated futures contracts in that they do not call for daily variation margin to reflect market changes, and in that the interbank market has no mechanism for settlement terminating a taxpayer's position prior to the delivery date.[73/]

[71/] See Section 1256(b).

[72/] See Pub. L. No. 97-448, § 105(c)(5)(C), 96 Stat. 2365, 2386 (1983); Section 1256(g)(1).

[73/] H.R. Rep. No. 794, 97th Cong., 2d Sess. 23 (1982).

The purpose of this amendment was to restore the comparable tax treatment of foreign currency RFCs and foreign currency bank forward contracts which was upset by ERTA, since the two types of contracts are economically interchangeable.[74] This special rule for bank forward contracts, which was urged by industry representatives,[75] extends RFC treatment to a type of contract that is not traded on a mark to market basis or even on an exchange. Thus, Congress is applying a mark to market concept in a context that is substantially different from the application of the mark to market concept to standard RFCs. As is pointed out below, the policy justifications for extending RFC treatment to exchange-traded options is stronger than the policy justifications for treating foreign currency contracts as RFCs.

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[74] See H.R. Rep. No. 794, 97th Cong., 2d Sess. 23 (1982). The report further says:

> Prior to ERTA, taxpayers who used both the futures exchanges and the interbank market to conduct short term trading in foreign currency were subject to substantially comparable tax treatment for both types of contract. Although bank forward contracts differ from regulated futures contracts, the volume of trading through forward contracts in foreign currency in the interbank market is substantially greater than foreign currency trading on futures exchanges, and prices are readily available. Such contracts are economically comparable to regulated futures contracts in the same currencies and are used interchangeably with regulated futures contracts by traders.

[75] See Letter from Frank V. Battle, Jr. to Thomas Gallagher, Attorney-Advisor, Tax Legislative Counsel's Office (Dec. 8, 1981), reprinted as Tax Notes Documents No. 81-12076; Letter from Donald C. Lubick to Robert Woodward, Acting Associate Tax Legislative Counsel (July 12, 1982), reprinted as Tax Notes Documents No. 82-7832.

C. Operation of Section 1256

Section 1256(a)(1) provides that "each [RFC] held by the taxpayer at the close of the taxable year shall be treated as sold for its fair market value on the last business day of such taxable year (and any gain or loss shall be taken into account for the taxable year)...." Under this basic rule, open contracts are deemed to have been disposed of at the close of the taxable year. A contracts's "fair market value" will ordinarily be considered the same as the settlement price determined by the exchange for the futures contract on the last business day of the year.[76]

Under section 1256(a)(3), any gain or loss with respect to any RFCs closed during the taxable year or open at year end is treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. Since the maximum tax rate on individuals is now fifty percent, the maximum effective tax rate on an individual's income from RFCs is thirty-two percent. A taxpayer may elect to carry RFC losses back three years to offset prior RFC gains[77] and there is an unlimited carry forward of such losses.[78] Since the mark to market system began in 1981, that year is the earliest year to which RFC losses may be carried.[79]

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[76] See S. Rep. No. 144, 97th Cong., 1st Sess. 157.

Futures contracts can be closed out either by making or taking delivery of the cash commodity or by making an opposite, or offsetting, futures transaction. Section 1256(c) provides that contracts terminated during the taxable year "by offsetting, by taking or making delivery, or otherwise" shall be treated in accordance with the rules that apply to open RFCs.[80] "Gain or loss upon termination is [to be] determined on the basis of the contract's fair market value at the time of termination, ordinarily the actual price received or paid."[81]

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[77] See Pub. L. No. 97-34, § 504, 95 Stat. 172, 330-31 (1981); Section 1212(c)(1).

[78] See Section 1212(b).

[79] See S. Rep. No. 144, 97th Cong., 1st Sess. 163.

[80] Section 1256(c)(1).

[81] S. Rep. No. 144, 97th Cong., 1st Sess. 158.

The Technical Corrections Act amended section 1256(c) to clarify that a "transfer" of a taxpayer's rights in an RFC is to be treated as a termination (i.e., a taxable event),[82] and gains and losses are to be taken into account as though the RFC were terminated by offset or delivery.[83]

The Technical Corrections Act also amended the termination rule to require that if a taxpayer holds a straddle that includes two or more RFCs, then all the contracts are to be treated as terminated on the date the taxpayer takes delivery on any of the contracts.[84]

As is demonstrated from the following discussion, the tax treatment of futures contracts prior to the enactment of ERTA was essentially comparable with the tax treatment of options. Under prior law, the closing of a long futures contract by offset was deemed to be a sale or exchange[85] and the taxpayer had capital gain or loss[86] unless the taxpayer came within the nonstatutory hedging exemption.[87] This rule obtains today under section 1234(a) for the holder of a put or call option who closes out such option by offset.[88] Because a long futures contract qualified for the special six month holding period under section 1222, a taxpayer who had held a long futures contract for the required six months would have had long-term capital gain or loss on the closing transaction. Although it is not possible currently to receive long-term capital gain from the holding of an exchange-traded option (such options have a maximum holding period of 9 months), it should be noted that Senator Dole has a bill[89] before Congress that, if enacted, would reduce the long-term holding period for all property to 6 months.

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[82] See Pub. L. No. 97-448, § 105(c)(1), 96 Stat. 2365, 2385 (1983); Section 1256(c)(1).

[83] See id. See also H.R. Rep. No. 794, 97th Cong., 2d Sess. 23-24 (1982).

[84] See Pub. L. No. 97-448, § 105(c)(1), 96 Stat. 2365, 2385 (1983); Section 1256(c)(2).

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[85] See Comm'r v. Covington, 120 F.2d 768 (5th Cir. 1941), *cert. denied*, 315 U.S. 822 (1942).

[86] See Faroll v. Jarecki, 231 F.2d 281 (7th Cir.), *cert. denied*, 352 U.S. 830 (1956).

[87] See Corn Products v. Comm'r, 350 U.S. 46 (1955); Rev. Rul. 72-179, 1972-1 C.B. 57.

[88] It should be noted that an options dealer has ordinary income or loss with respect to options acquired or granted in the ordinary course of his trade or business. See discussion *supra* at notes 25 to 27 and supporting text. Many if not most of an options dealer's transactions are hedges.

[89] S. 13.

Prior to ERTA, the closing of a long futures contract by making payment of the purchase price and taking delivery of the cash commodity was not a recognition event.[90/] Any gain inherent in the long futures contract was rolled into the cash commodity upon taking delivery,[91/] and the holding period of the cash commodity included the holding period of the long futures contract, provided that the long futures contract was a capital asset.[92/] These same principles apply currently to the exercise of a call option, except that the holding period of the property begins on the date of exercise.

The closing of a short futures contract by offset under prior law may have produced short-term capital gain or loss as a result of the short sale rule of section 1233(b). Under section 1234(b), the grantor of a put or call option has short-term capital gain or loss upon offset or lapse.

[90/] See Rev. Rul. 79-294, 1979-2 C.B. 305. See also Rev. Rul. 78-182, 1978-1 C.B. 265; Rev. Rul. 58-234, 1958-1 C.B. 279.

[91/] See Rev. Rul. 78-182, 1978-1 C.B. 265; Rev. Rul. 58-234, 1958-1 C.B. 279.

[92/] See Section 1223(8) prior to amendment by the Technical Corrections Act of 1982.

The closing of a short futures contract by making delivery of the cash commodity resulted under prior law in ordinary income or loss or capital gain or loss depending upon the character of the commodity delivered. This same rule applies today upon the exercise of a put.

Although there were some differences under prior law in the tax treatment of options and futures, there was essential parity in such treatment. With the mark to market rule, ERTA upset the substantially comparable tax treatment for options and futures.

D. Applicability of Section 1092

Section 1256(a)(4) provides that "if all the offsetting positions making up any straddle consist of regulated futures contracts (and such straddle is not part of a larger straddle)," then the loss deferral rules of section 1092 and the capitalization of carrying costs rule of section 263(g) do not apply to such straddle.[93] However, if a taxpayer enters into a straddle consisting of an RFC and a non-RFC, both of these provisions apply to the RFC and the non-RFC.

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[93] For a definition of the term "straddle," see pages 23 and 24 supra.

In addition, section 1256 applies to the RFC[94] unless the taxpayer elects to have such straddle identified as a "mixed straddle" in accordance with the rules of section 1256(d). If the taxpayer identifies such a straddle as a "mixed straddle," section 1256 does not apply to the RFC,[95] and the taxpayer recognizes short-term capital gain or loss on the RFC when realized.

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[94] See S. Rep. No. 144, 97th Cong., 1st Sess. 158-59. The Senate Finance Committee Report explains the treatment of an unidentified mixed straddle:

> If a taxpayer fails to identify the positions constituting a mixed straddle, or, if a taxpayer fails to make an election of a consistent tax treatment for all the positions in such a straddle, the amount of any gain or loss on futures contracts in the straddle is determined under the mark-to-market rules. Gain or loss on other positions in the straddle is determined under the regular tax rules. All positions in the straddle, both futures contracts and other property, are subject to the loss deferral rule in § 1092, the modifications of the wash sale and short sale rules applicable to straddles, and the capitalization rule in § 263(g). The application of § 1092 to such unidentified mixed straddles will result in the deferral of all losses with respect to which there is offsetting unrealized gain, so that losses realized on the mark-to-market system are deferred to the extent there are unrealized gains in other property. Similarly, losses on property outside the mark-to-market system are deductible to the extent of gains on futures contracts in the mark-to-market system (provided there are no unrealized gains in other offsetting positions).

[95] Section 1256(d)(1).

A mixed straddle is defined as any straddle:

> (A) at least 1 (but not all) of the positions of which are regulated futures contracts, and
> (B) with respect to which each position forming part of such straddle is clearly identified, before the close of the day on which the first regulated futures contract forming part of the straddle is acquired, as being part of such straddle.96/

As an example, consider a taxpayer who on the same day buys a Treasury Bill RFC (a long position) and acquires an offsetting Treasury Bill put option (a short position). If, before the close of the day, the taxpayer identifies both positions as being part of a mixed straddle, the T-bill RFC is not subject to the mark to market rule of section 1256.97/ Instead, both positions are subject only to the loss deferral rules of section 1092 and the capitalization of carrying costs rule of section 263(g).98/ An election under section 1256(d) applies to the taxable year for which it was made and to all subsequent years, unless the Secretary consents to a revocation.99/

96/ Section 1256(d)(4).

97/ Section 1256(d)(1).

98/ *See* S. Rep. No. 144, 97th Cong., 1st Sess. 158.

99/ Section 1256(d)(3). The election is to be made at the time and in the manner specified in regulations. Section 1256(d)(2).

Under present law, it is uncertain whether the Treasury, pursuant to section 1092(b), will attempt to apply the principles of the short sale rules of section 1233 to the RFC position of an unidentified mixed straddle to convert the 60 percent long-term capital gain to short-term capital gain and the 40 percent short-term capital loss to long-term capital loss.

E. The Hedging Exemption

The mark to market and 60/40 rules of section 1256 and the loss deferral rules of section 1092 do not apply to transactions which qualify under the hedging exemption of section 1256(e).[100]

REASONS FOR CHANGE

I. INTRODUCTION

As a result of the straddle provisions of ERTA, most of the tax motivated straddle transactions have been curtailed; however, under current law these provisions do not apply to offsetting positions in stock options. One of the additional results of the straddle provisions was to create different tax regimes for options and for futures, which are essentially comparable products. As is pointed out below, this significant discontinuity in the tax treatment of options and futures tends to decrease economic efficiency by distorting investment decisions. Further, as noted below, there continue to be uncertainties in the tax treatment of cash settlement options and commodity options. Accordingly, this legislative proposal would:

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[100] *See* discussion of hedging exemption at text accompanying notes 58 through 63 *supra*.

(1) limit the deferral of short-term capital gain and ordinary income through essentially riskless transactions;

(2) treat comparable investment products under the same general tax rules;

(3) clarify the uncertainties under present law as to the tax consequences of an investment in certain newly created investment products; and

(4) rationalize the provisions of section 1092 to ensure the continued use of the security exchanges and boards of trade for bona fide economic transactions.

II. STOCK OPTION STRADDLES

Under present law, exchange-traded stock options are not subject to the loss deferral rules of section 1092.[101] The principal reasons for this limited exclusion for exchange-traded stock options are that it is not possible to convert short-term capital gain into long-term capital gain with stock options[102] and that, although taxpayers may use such options to defer taxation of short-term capital gain or ordinary income,[103] there did not appear at the time of the enactment of ERTA to have been any significant tax abuse with such options.

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[101] Section 1092(d)(2)(B).

Since the enactment of section 1092, certain tax motivated transactions appear to have developed. The Treasury recently outlined these transactions as follows:

> Since the enactment of ERTA, we have seen substantial indications that investors are attempting to defer the taxation of income through tax straddles in exchange-traded stock options. These transactions have taken two forms:
>
> - Limited partnerships of wealthy investors claim to be acting as market markers in stock options. Straddle transactions in stock options are undertaken to produce losses, which are passed through to investors as ordinary losses.
>
> - Investors take offsetting positions in stock options -- typically deep-in-the-money options which have a smaller time premium and more predictable response to price fluctuations in the underlying stock -- to defer short-term capital gains by taking the short-term capital loss on the loss leg of the straddle. [footnote omitted][104]

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[102] See S. Rep. No. 144, 97th Cong., 1st Sess. 151.

[103] A deferral of income through the use of straddles is presently subject to challenge under the rationale of Smith v. Commissioner, 78 T. C. 350 (1982), and Rev. Rul. 77-185, 1977-1 C.B. 48.

[104] Statement of Robert G. Woodward, Acting Tax Legislative Counsel, Department of the Treasury, Before the Subcommittee on Oversight of the Internal Revenue Service Senate Committee on Finance (June 24, 1983), pp. 5-7.

The Treasury went on to suggest that Congress (1) re-examine the exemption for stock options, and (2) enact rules to eliminate the use of market maker partnerships:

> In our view, the ability to defer substantial amounts of income through essentially riskless transactions in stock options is just as objectionable as the straddling in regulated futures contracts and other actively traded property that occurred prior to enactment of Title V of ERTA. The deferral of tax liability claimed to be achieved through these transactions is, in substance, an interest-free loan of the deferred tax from the government. Alternatively, such deferral can be viewed as an actual reduction of tax liability as a result of the time value of money. We therefore believe that Congress should re-examine the exemption of exchange-traded stock options from the loss deferral rules. Certainly, we would favor a mechanical rule that would prevent the use of so-called market maker partnerships comprised of more than 35 percent limited partners from claiming ordinary losses in order to defer taxation of ordinary income. Such rules are provided in S. 13, recently introduced by Senator Dole and others to provide for the reduction of the long-term capital gains holding period to six months.[105]

This legislative proposal would specifically address the concerns expressed by the Treasury by amending section 1092 to bring stock options (and stock to the extent offset by an option) within the general loss deferral rules, thereby eliminating the potential for (1) investors to defer short-term capital gain, and (2) market maker partnerships to defer ordinary income.

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[105] Id.

III. TAXATION OF COMPARABLE INVESTMENT PRODUCTS

A taxpayer may choose to trade comparable investment products on either a security exchange or a board of trade. As examples, a taxpayer has the opportunity to buy or sell options or futures on Treasury bills, Treasury bonds, foreign currencies, the Standard and Poor 100 Index and the Standard and Poor 500 Index. In each of these examples, the underlying product or index is identical for both options and futures. Also, a taxpayer has the opportunity to buy or sell security options or commodity options with respect to the same or similar underlying property.

Under present law, a taxpayer is subject to a different rate of tax depending on whether the taxpayer chooses to trade an option or a future. In those cases where a taxpayer uses the security exchanges, the taxpayer recognizes short-term capital gain or loss or ordinary income or loss. In those cases where a taxpayer trades a comparable product on a board of trade, the taxpayer recognizes gain or loss as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. Further, in view of the present uncertainty concerning the taxation of commodity options, it is possible for the Treasury to be whipsawed by having taxpayers who trade such options at a gain claim 60 percent long-term capital gain and 40 percent short-term capital gain (pursuant to the view expressed by certain commodity exchanges) while other taxpayers who trade such options at a loss claim 100 percent short-term capital loss (pursuant to the view expressed by certain security exchanges).

Although options and futures in large measure perform the same economic functions, the following example is just one illustration of how the disparity in tax treatment of the two products can distort rational economic decision making:

> Let us assume that an investor thinks that interest rates will decline and that bond prices will therefore increase. The investor wants to profit from the anticipated increase. His broker advises him that he can accomplish his investment goals by purchasing a T bond call option or by entering into a long T bond futures contract. The long call option and the long futures contract perform the same basic function: they each permit the investor to profit from the anticipated rise in the T bond market.
>
> The broker further advises that the principal difference between a long call and a long future is that in the case of the call, the investor's risk of loss is limited to the premium paid; whereas, in the case of a long futures contract the investor has a theoretical risk of loss equal to the value of the underlying T bond at the time the transaction is entered into. On the other hand, the broker points out that as a practical matter as long as the futures market for T bonds continues to be liquid, the holder of the long futures contract will be able to limit his loss by closing out his position if the market goes down.

Let us assume that the investor is risk averse and that he therefore decides to buy the call option and limit his risk to the premium while having unlimited potential for gain.

The investor, therefore, purely on a risk/reward analysis, tells the broker to go ahead and acquire the T bond option. The broker says:

> "Fine, but I must tell you that if you make $1,000 on the future, your tax liability will be $320, but if you make $1,000 on the option, you will have a $500 tax liability. On the other hand, assuming you have no other capital transactions for the year, if you lose $1,000 on the futures contract, you will have a $700 deduction against ordinary income. Whereas, if you lose $1,000 on the option, you will have a $1,000 deduction against ordinary income."

The broker then points out that if the investor enters into the futures contract and the contract is open at year end, he will be marked to market. "But," the broker continues:

> "That's not much of a burden because variation margin flows through, and in any event, if you are marked at a gain and you want to be sure you have the cash to pay the tax, you can close out your contract early the following year."

The investor is therefore put in a dilemma. Although, based on his risk preferences he would buy the call option and limit his risk, if he does so, he will bear a significantly higher tax liability than he would incur if he enters into the futures contract and the market price of bonds in fact increases. Therefore, his basic judgment might be altered by the significant differences in the tax treatment of futures and options. Such differences clearly tend to decrease economic efficiency by causing taxpayers to alter their economic decisions with respect to essentially comparable products.

This legislative proposal would eliminate the tax disparities by providing for a taxpayer election to have gains and losses from security, index, physical, and commodity options marked to market and taxed as 60 percent long-term and 40 percent short-term capital gain or loss.

IV. CLARIFICATION OF TAX TREATMENT OF NEW PRODUCTS

Under present law, the tax treatment of cash settlement options and commodity options is either not expressly covered by the Code or is in dispute. This proposal would clarify that, for a taxpayer who does not elect RFC treatment for options, gain or loss with respect to cash settlement options is short-term capital gain or loss to an investor and ordinary income or loss to a taxpayer who "makes a market" in the option pursuant to the rules of a security exchange. This proposal would also clarify that for the non-electing taxpayer, gain or loss with respect to a commodity option is in all events short-term capital gain or loss and that gain or loss is recognized upon exercise of the commodity option.

V. EXCLUSION OF CERTAIN OPTION WRITING TRANSACTIONS FROM STRADDLE RULES

Under present law, section 1092 provides that "[a] taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding one or more other positions with respect to personal property (whether or not of the same kind)."[106] It is uncertain whether section 1092 would apply to certain covered call transactions where an investor who holds stock or bonds writes call options with respect to such instruments. Covered call transactions are one of the most prevalent investment strategies used by investors in options. These transactions have a bona fide economic purpose and are not tax avoidance devices, since the principal purpose of writing a covered call is to increase the total investment return from continued ownership of the stock or debt instruments. In view of the fact that this proposal would bring stock options (and stock to the extent offset by options) within the loss deferral rules, the proposal would amend the offsetting position rules to make it clear that certain non-deep in the money option writing transactions are not subject to the loss deferral rules.

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[106] Section 1092(c)(2)(A).

EXPLANATION OF PROVISIONS

I. INTRODUCTION

Under the proposal, a taxpayer may file a one time election[107] with the Secretary to have "listed option contracts"[108] become subject to the provisions of section 1256.[109] If a taxpayer does not file the election provided for in new section 1256(i), the taxpayer who trades exchange-traded options or commodity options would be subject to section 1092 and section 1234, as amended by this proposal.

II. EXPLANATION OF PROVISIONS AFFECTING NON-ELECTING TAXPAYER

A. In General

The proposal amends sections 1092, 1234 and 263(g) to eliminate possible tax motivated straddle transactions and to clarify the present tax treatment of cash settlement options and commodity options. In general, section 1092 is amended to bring stock options (and stock to a limited extent) within the definition of "position"[110] and to exclude non-tax motivated option writing transactions from the loss deferral rules.[111]

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[107] See New Section 1256(i). See Appendix B.

[108] New Section 1256(h) defines a "listed option contract" to include all exchange-traded options and options traded on a board of trade.

[109] See New Section 1256(b).

[110] See New Section 1092(d)(2). See Appendix A.

B. Section 1092

1. Inclusion of Stock Options in the Definition of "Position"

New section 1092(d)(2) deletes the exemption of stock options from the definition of "position." Accordingly, investors who enter into offsetting positions in stock options would be subject to the general loss deferral rules of section 1092(a) and (b) and any realized loss with respect to a position would be allowed only to the extent such loss exceeds the unrecognized gain with respect to an offsetting position. This amendment would prevent an investor from deferring short-term capital gain through the use of stock option straddles.

The inclusion of stock options within the definition of position would also prevent "syndicate" limited partners from deferring ordinary income through the use of stock option straddles.[112] This is so because the loss deferral rules of section 1092 would apply to transactions entered into by the limited partnership, unless the hedging exemption of section 1256(e) applied to the transactions.[113] Under present law, the hedging exemption of section 1256(e) does not apply to "syndicates."[114] A syndicate for purposes of section 1256(e) is defined as "any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited enterpreneurs (within the meaning of section 464(e)(2))."[115]

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[111] See New Sections 1092(c)(2)(D).

[112] Under present law, these transactions are subject to attack under the rationales of Smith v. Commissioner, 78 T.C. 350 (1982) and Rev. Rul. 77-185, 1977-1 C.B. 48.

2. Limited Inclusion of Stock in the Definition of "Position"

This proposal would amend the definition of "personal property" by including an interest in stock (or a short position in stock) within the definition of "position" to the extent stock (or a short position in stock) is offset by an option.[116] As explained more fully in section 3. below, under new section 1092(c)(2)(D), stock (or a short position in stock) would be brought within the offsetting position rules only if stock (or a short position in stock) is offset by an option in an essentially riskless transaction. This limited inclusion is consistent with the purposes of section 1092 which excludes from the definition of "straddle" those positions which do not substantially diminish an investor's risk of loss.[117]

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[113] *See* section 1092(e).

[114] Section 1256(e)(3)(A).

[115] Section 1256(e)(3)(B).

[116] *See* New Sections 1092(d)(1) and 1092(d)(2)(B).

3. Exclusion of Certain Option Transactions from the Definition of "Offsetting Position"

As explained in Exhibit F, covered call writing is a commonly used investment strategy to increase investment returns on stock and securities. In this type of transaction a taxpayer writes a call with respect to stock or securities that he holds. Although any loss from the call side of such a transaction may be substantially offset by gain on the stock or securities side, any loss on the stock or securities side is reduced only to the extent of the call premium. If the call is not "deep in the money," the call will not substantially reduce the taxpayer's risk of loss from holding the underlying stock or securities.

Since an investor never knows when he writes a call option whether the price of the stock or securities will decrease or increase, there is substantial economic risk associated with a non-deep in the money call transaction if the value of the stock or securities decreases. This suggests that the appropriate way of analyzing whether a covered call transaction is an "offsetting position" within the meaning of section 1092(c)(2)(A) is to determine whether the premium taken in on the writing of the call "substantially" decreases the taxpayer's risk of loss of holding the stock or securities.

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[117] *See* section 1092(c)(2)(A).

This in turn requires a determination of the meaning of the term "substantial." In this regard, it should be noted that the Internal Revenue Service has ruled in the collapsible corporation area that "a substantial part" means a third of a whole.[118] If that interpretation were applied in this context it would mean that the call would not substantially diminish the risk of loss of holding the stock or securities unless the premium taken in were more than a third of the "risk of loss" of holding the stock or securities. Although the risk of loss of holding stock or a security is theoretically the full value thereof, as a practical matter the probability of a 100 percent loss is slight. Therefore, it might be appropriate in determining the "risk of loss" of holding a particular stock or security to look at the probability of price movement.

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[118] *See* Rev. Rul. 72-48, 1972-1 C.B. 102.

In an effort to determine the extent to which a call must be in the money in order to diminish the risk of loss of holding an underlying stock or security by more than a third, the Chicago Board Options Exchange, Inc. ("CBOE") conducted a study, which covered five different days and included price information (option closing price, stock closing price and strike price) for all stock option series on the January 1982 cycle which had three months remaining until expiration. The first step of the analysis involved calculating for each option series for each day the percent the option was in the money. All in the money options were then ranked according to their corresponding percentages and were stratified in four categories: 0 to 5%, 5% to 10%, 10% to 15%, and 15% to 20% in the money. In ascertaining the risk of loss associated with the underlying stock, volatility estimates (standard deviation of returns) for each stock in the samples were obtained from "Daily Graphs" issued one week prior to the date selected for analysis. The risk of loss was measured at two standard deviations, which accounted for approximately 95 percent of the expected price movements.

The results of the study are set forth in the following chart:

Risk Measured as Two Standard Deviations

% in the money	Less than 33%	Greater than 33%	Total
0 - 5%	193	0	193
5% - 10%	154	1	155
10% - 15%	125	16	141
15% - 20%	48	54	102
Total of series	520	71	591

The study suggests that a call option which is not more than 15 percent in the money is unlikely to protect an investor from more than 33 percent of the risk of loss (measured at two standard deviations) associated with owning the underlying stock or security. Although the study did not involve debt options, similar results should obtain with respect to such options.

This proposal would add New Section 1092(c)(2)(D) which is a statutory exclusion from the offsetting position rules for stock or securities and a call option written by the taxpayer where the exercise price is at least 85 percent of the fair market value of the underlying stock or securities. This exclusion would ensure that a non-tax motivated covered call writing program involving either a stock or a security is not subject to the loss deferral rules. For the same reasons non-deep in the money covered calls are exempt, New Section 1092(c)(2)(D) would also exempt from the offsetting position rule a short sale of stock or security and a put written by the taxpayer where the fair market value of the stock or security is at least 85 percent of the exercise price of the option. Such a transaction does not substantially diminish a taxpayer's risk of loss with respect to the short sale.

The CBOE would also like to explore with the Treasury the possibility of assisting the Treasury in drafting regulations which define "offsetting position" for transactions involving options.

4. Tax Treatment of Options Dealer

This proposal provides that the present tax treatment of an options dealer who does not file the election provided for in section 1256(i) shall continue. Accordingly, an options dealer will continue to realize ordinary income or loss on options granted and acquired in the ordinary course of his trade or business of granting and acquiring options.[119] It is also intended that an options dealer will continue to recognize ordinary income or loss with respect to his stock and security transactions where such transactions are in the ordinary course of the options dealer's trade or business of granting and acquiring options. Under this proposal, those transactions of an options dealer which satisfy the hedging exemption of section 1256(e) will continue to be excluded from the loss deferral rules.[120]

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[119] *See* Reg. § 1.1234-3(c).

C. Section 1234

1. Cash Settlement Options

Under this proposal, section 1234 would be amended to clarify that under present law gain or loss with respect to the writer or holder of a cash settlement option is short-term capital gain or loss on the sale, exchange, lapse, or exercise of such option.[121] The term "cash settlement option" is defined to mean "any option . . . which settles in (or could be settled in) cash or property other than the underlying property on exercise."[122] Thus, an option on a commodity or a stock index which settled in cash would be a cash settlement option as would an option on a commodity which settled in a different type of commodity. The proposed statutory amendments follow the general statutory provisions of section 1234 with respect to options dealers by specifically providing that gain or loss with respect to cash settlement options acquired and granted in the ordinary course of the taxpayer's trade or business is ordinary income or loss.[123]

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[120] *See* section 1092(e).

[121] New Section 1234(c)(1). *See* Appendix C.

[122] New Section 1234(c)(2).

2. Commodity Options

This proposal would amend section 1234 to provide that gain or loss with respect to commodity options is short-term capital gain or loss.[124] The amendment further provides that the exercise of a commodity option constitutes a recognition event.[125] Thus, while in the case of other option transactions where exercise constitutes a recognition event only for a writer of a call or a holder of a put, with respect to commodity options, exercise will constitute a recognition event for a holder of a call and a writer of a put as well. This amendment is intended to prevent the conversion of short-term capital gain with respect to the commodity option to 60 percent long-term capital gain and 40 percent short-term capital gain.

D. Section 263(g)

Section 263(g) would be amended under this proposal to include "dividends and all other amounts" in the calculation of interest and carrying charges.[126] This amendment is intended to conform the present statute to the proposed limited inclusion of stock within the loss deferral rules.[127]

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[123] New Section 1234(c)(4).

[124] New Section 1234(c)(1).

[125] New Section 1234(c)(1).

[126] New Section 263(g)(2)(B)(i). *See* Appendix E.

III. TAX TREATMENT OF ELECTING TAXPAYER

A. Election

This proposal would amend section 1256 to provide that a taxpayer may file a one-time election to have listed option contracts taxed within the mark to market system.[128] This legislative proposal provides for an elective rather than a mandatory inclusion in section 1256, because of tax policy concerns about the application of a mandatory mark to market concept to investment products that are not traded on a mark to market system.[129] In addition, the election should cause minimal disruption of the option markets, since the election applies only if a particular taxpayer decides that such election is appropriate.[130] In addition, a taxpayer election should not create opportunities for tax abuse.

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[127] *See* New Section 1092(d)(2)(B).

[128] New Section 1256(i) and New Section 1256(b).

[129] *See*, *e.g.*, *Eisner v. Macomber*, 252 U.S. 189 (1920)

[130] Bank forward contracts are subject to section 1256, even though such contracts do not provide for daily variation margin to reflect market changes. *See* section 1256(b).

The election as presently drafted applies only to listed option contracts. However, if the Treasury would want complete parity between options and futures, taxpayers could be given an election to have their futures contracts be marked to market under section 1256 or be subject only to the loss deferral rules of section 1092. Such an election for futures should also not give rise to any tax abuse.

B. Listed Option Contract Defined

New section 1256(h) defines a listed option contract to mean:

> any option (other than any right to acquire stock from an issuer) which is traded on a domestic exchange, a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or a similar foreign exchange or foreign board of trade which the Secretary determines has rules adequate to carry out the purposes of this section.

A listed option contract therefore includes any option traded on a domestic exchange and commodity options traded on a board of trade, but does not include a warrant issued by a corporation.[131] The definition also permits the Secretary to designate options or futures traded on foreign exchanges and boards of trade as coming within section 1256.[132]

C. Character of Listed Option Contract

This legislative proposal would amend section 1256(f)(2) to provide that:

> gain or loss from the trading of regulated futures contracts (whether or not such trading is in the ordinary course of the taxpayer's trade or business of trading regulated futures contracts) shall be considered gain or loss from the sale or exchange of a capital asset except to the extent the regulated futures contract is held for the purpose of hedging property that is ordinary income or loss property in the hands of the taxpayer. In no case will property underlying a regulated futures contract be deemed to be ordinary income or loss property in the hands of the taxpayer solely by reason of the fact that the taxpayer is in the trade or business of trading regulated futures contracts.

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[131] It should be noted that certain options which may be traded on a domestic exchange or board of trade following regulatory approval, such as options on physical property, would also become a listed option contract under this definition.

[132] Under the proposed amendments, section 1256(b) would define "regulated futures contract" to include futures contracts, bank forward contracts, board of trade commodity options and exchange-traded options. Accordingly, it may be appropriate to delete the reference to "futures" in "regulated futures contracts" and refer to these products as "regulated contracts."

The purpose of this amendment is to provide that both the options dealer and the professional commodity trader will be treated as buying or selling capital assets, except to the extent the option or future is acquired to hedge underlying ordinary income (or loss) property[132] (whether or not such options or futures are identified as being part of hedging transactions).[133]

Although this proposal changes present law by treating options, held by a taxpayer who "makes a market" in options, as capital assets, this proposal treats the professional options dealer the same as the professional commodity trader. Both the professional options dealer and professional commodity trader actively engage in the buying or selling of essentially equivalent products and, therefore, perform a similar function of providing liquidity in the options and futures markets. This essential similarity between the trading activities of the professional options dealer and of the professional commodity trader is apparent, even though under the case law the professional commodity trader recognizes capital gain or loss on his futures transactions, unless such futures transactions are part of hedging transactions.[134] It should be noted, however, that the issue of whether a commodity trader is engaged in the trade or business of buying and selling futures contracts and, therefore, recognizes ordinary income (or loss), instead of capital gain (or loss), continues to be raised by taxpayers claiming an ordinary loss deduction.[135] To the extent the present law is uncertain, that uncertainty could affect whether a professional commodity trader recognizes ordinary income or loss under section 1256.[136] Thus, in addition to treating options dealers as recognizing capital gains and losses with respect to their option transactions, the above language would eliminate any uncertainty as to whether professional commodity traders should recognize ordinary income or loss with respect to their futures transactions.

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[132] New Section 1256(f)(2). It is intended that this proposed amendment will clarify that the Corn Products doctrine is not changed by the amendment to section 1256(f)(2). See General Explanation at 297, 300.

[133] See Section 1256(f)(1). This proposal would also amend section 1236 to clarify that an options dealer who files an election would no longer be a securities dealer with respect to his options for purposes of section 1236. See New Section 1236(f). See Appendix D.

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[134] In this regard, a professional commodity trader has historically received capital gain or loss with respect to his futures transactions. See Faroll v. Jarecki, 231 F.2d 281 (7th Cir.), cert. denied, 352 U.S. 830 (1956); Comm'r v. Covington, 120 F.2d 768 (5th Cir. 1941), cert. denied, 315 U.S. 822 (1942). Cf. Reg. § 1.471-5 ("a dealer in securities is a merchant of securities, ...; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom.").

[135] See, e.g., Cleveland v. Comm'r, 46 T.C.M. 257, 279 (1983) (based on the facts and circumstances of the case, the court found that the taxpayer "was not in the trade or business of commodity trading." Accordingly, the taxpayer's losses were capital.).

[136] See section 1256(f)(2).

This legislative proposal also provides that a professional options dealer who files an election under section 1256(i) would no longer recognize ordinary income or loss with respect to his stock and securities transactions, unless such taxpayer were a dealer in the stock and securities under general federal income tax principles.[137] The purpose of this provision is to provide that the stock and security transactions of a taxpayer engaged in the business of trading regulated futures contracts would not give rise to ordinary income or loss solely by reason of the fact that options produce ordinary income or loss under current law.

Finally, the proposal specifically provides that a taxpayer's status under current law for purposes of section 1091 would not be changed for those taxpayers who file an election under new section 1256(i). Accordingly, for purposes of section 1091 the status of an electing taxpayer under current law as one who is engaged in a trade or business of trading, or who is a dealer in, stock or securities would continue. Thus, if an options dealer is presently exempt under section 1091 with respect to his stock or security transactions such dealer would continue to be exempt under section 1091 even though he files an election under section 1256(i).

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[137] New Section 1256(f)(2).

D. Application of Section 1256 to Listed Option Contracts

1. In General

Because this legislative proposal would bring listed option contracts within the general rules of section 1256, a taxpayer for whom the election in section 1256(i) is in effect would be treated the same as a taxpayer who trades futures contracts. Accordingly, the present rules under section 1256 would apply.[138] This legislative proposal would also amend the termination provisions of section 1256(c)(1) so that a taxpayer would recognize gain or loss with respect to a listed option contract upon exercise, lapse, or entering into an offsetting position.[139]

It is suggested that the legislative history make it clear that the following rules would apply in determining the basis of property received on exercise of a listed option contract:

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[138] See discussion of present law at pages 34 to 46 supra.

[139] See New Section 1256(c).

(a) The basis of stock or a security received by exercise of a call option shall be the same as the basis of the option increased by the amount paid for the stock or security under the terms of the option and increased by any gain (or decreased by any loss) taken into account upon exercise of the option, and

(b) The basis of stock or a security received by assignment of a put option shall be the amount paid for the stock or security under the terms of the option decreased by the premium received for the option and decreased by any loss (or increased by any gain) taken into account upon assignment of the option.

2. Hedging Transactions

Under this legislative proposal, a taxpayer who is a "dealer" in stock or securities would be treated the same as a taxpayer who is a "dealer" in a cash commodity. Accordingly, the 60-40 rule of section 1256(a)(3) would not apply to option positions acquired or granted to reduce the risk of holding underlying ordinary income (or loss) stock or securities. As with the current treatment of RFCs, neither sections 1092 nor 1256 would apply to a taxpayer who identifies such transactions as hedging transactions and gain or loss with respect to the option and stock or security positions would be recognized as ordinary income or loss when realized. However, sections 1092 and 1256 would apply (except for the 60-40 rule of section 1256(a)(3)) to a taxpayer who fails to identify the hedged positions and, accordingly, a listed option contract which is acquired for the purpose of hedging underlying ordinary income stock or securities but which is not identified as part of a hedging transaction would be marked to market and any gain or loss would be ordinary income or loss.

Finally, it should be noted that a securities dealer may presently use RFCs to hedge his security positions and the RFCs are exempt from both sections 1256 and 1092 provided the requirements of section 1256(e) are met. This same principle would apply under this proposal to listed option contracts that the securities dealer uses to hedge his securities positions.

E. Applicability of Section 1092(b) to a Mixed Straddle

Under current law, a straddle consisting of an RFC and a non-RFC is subject to the loss deferral rules of section 1092, and unless the taxpayer makes the "mixed straddle" election provided for in section 1256(d), the RFC position is subject to the mark to market rules of section 1256. Thus, depending upon which leg generates gain, such transactions could result in the conversion of unrelated long-term capital gain into short-term capital gain, or the conversion of unrelated short-term capital gain into long-term capital gain.

It is the view of the CBOE that the regulations to be written under section 1092(b) should both eliminate such conversion possibilities and allow a taxpayer to receive 60/40 treatment to the extent the gain from an RFC position of a mixed straddle exceeds the realized loss from the non-RFC position.

One way of accomplishing these two goals might be to apply the following rules to all types of unidentified mixed straddles:

> The gain or loss on the RFC position is first netted against any realized gain or loss on the non-RFC position, and
>
> (a) If the RFC gain exceeds the non-RFC loss, such excess gain will be treated as 60 percent long-term capital gain and 40 percent short-term capital gain;
>
> (b) If the RFC loss exceeds the non-RFC gain the excess loss will be 60 percent long-term capital loss and 40 percent short-term capital loss;
>
> (c) If the non-RFC gain exceeds the RFC loss the gain will be short-term capital gain unless the non-RFC position had been held for the long-term holding period at the time the taxpayer entered into the mixed straddle, in which case such gain would be long-term capital gain;
>
> (d) If the non-RFC loss exceeds the RFC gain, the loss will be short-term

> capital loss, unless the non-RFC position had been held for the long-term holding period at the time the mixed straddle had been entered into, in which case any loss would be long-term capital loss.

The CBOE would like to work with Treasury in developing regulations under section 1092(b) (or an amendment to 1092(b), if that is necessary) to reflect the above principles. Also, as indicated above, the CBOE would like to help Treasury develop a workable set of regulations which would apply the "offsetting position" rule of section 1092(c) to straddles involving listed option contracts.

F. Transitional Rules

1. Carryback of RFC Losses

Section 1212(c) provides that RFC losses may, at the election of the taxpayer, be carried back three years to offset RFC gains. Because taxpayers currently recognize short-term capital gain or ordinary income on their option transactions, a transitional rule would be proposed to provide that RFC losses from listed option contracts generated during the first three years after the enactment of the proposed statutory amendments could be carried back to offset pre-election short-term capital gain or ordinary income from option transactions. However, such pre-election short-term capital gain or ordinary income would be treated as 60/40 RFC gains for the purpose of the transitional carryback rule.

2. Pay-in Period

The CBOE suggests that a transitional rule be developed to provide a pay-in period for the tax imposed on deferred gain recognized as a result of an election to be subject to the mark to market rule.

G. Effective Date

The CBOE would like to work with Treasury in developing effective date rules.

EXHIBIT A

SEC. 1092. STRADDLES.

(a) Recognition of Loss in Case of Straddles, Etc. --

(1) Limitation on recognition of loss. --

(A) In general. -- Any loss with respect to 1 or more positions shall be taken into account for any taxable year only to the extent that the amount of such loss exceeds the unrecognized gain (if any) with respect to 1 or more positions which were offsetting positions with respect to 1 or more positions from which the loss arose.

(B) Carryover of Loss. -- Any loss which may not be taken into account under subparagraph (A) for any taxable year shall, subject to the limitations under subparagraph (A), be treated as sustained in the succeeding taxable year.

(2) Special rule for Identified Straddles. --

(A) In general. -- In the case of any straddle which is an identified straddle as of the close of any taxable year --

(i) paragraph (1) shall not apply for such taxable year, and

(ii) any loss with respect to such straddle shall be treated as sustained not earlier than the day on which all of the positions making up the straddle are disposed of.

(B) Identified straddle. -- The term "identified straddle" means any straddle --

(i) which is clearly identified on the taxpayer's records, before the close of the day on which the straddle is acquired, as an identified straddle,

(ii) all of the original positions of which (as identified by the taxpayer) are acquired on the same day and with respect to which --

(I) all of such positions are disposed of on the same day during the taxable year, or

(II) none of such positions has been disposed of as of the close of the taxable year, and

(iii) which is not part of a larger straddle.

(3) Unrecognized gain. -- For purposes of this subsection --

(A) In general. -- The term "unrecognized gain" means --

(i) in the case of any position held by by the taxpayer as of the close of the taxable year, the amount of gain which would be taken into account with respect to such position if such position were sold on the last business day of such taxable year at its fair market value, and

(ii) in the case of any position with respect to which, as of the close of the taxable year, gain has been realized but not recognized, the amount of gain so realized.

(B) Reporting of gain. --

(i) In general. -- Each taxpayer shall disclose to the Secretary, at such time and in such manner and form as the Secretary may prescribe by regulations --

(I) each position (whether or not part of a straddle) with respect to which, as of the close of the taxable year, there is unrecognized gain, and

(II) the amount of such unrecognized gain.

(ii) Reports not required in certain cases. -- Clause (i) shall not apply --

(I) to any position which is part of an identified straddle,

(II) to any position which, with respect to the taxpayer, is property described in paragraph (1) or (2) of section 1212 or to any position which is part of a hedging transaction (as defined in section 1256(e)), or

(III) with respect to any taxable year if no loss on a position (including a regulated futures contract) has been sustained during such taxable year or if the only loss sustained on such position is a loss described in subclause (II).

(b) Character of Gain or Loss; Wash Sales. -- Under regulations prescribed by the Secretary, in the case of gain or loss with respect to any position of a straddle, rules which are similar to the rules of subsections (a) and (d) of section 1091 and of subsections (b) and (d) of section 1233 and which are consistent with the purposes of this section shall apply.

(c) Straddle Defined. -- For purposes of this section --

(1) In general. -- The term "straddle" means offsetting positions with respect to personal property.

(2) Offsetting positions. --

(A) In general. -- A taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions with respect to personal property (whether or not of the same kind).

(B) One side larger than other side. -- If 1 or more positions offset only a portion of 1 or more other positions, the Secretary shall by regulations prescribe the method for determining the portion of such other positions which is to be taken into account for purposes of this section.

(C) Special rule for identified straddles. -- In the case of any position which is not part of an identified straddle (within the meaning of subsection (a)(2)(B)), such position shall not be treated as offsetting with respect to any position which is part of an identified straddle.

(D) Special rule for stock or debt instruments underlying options. - The term "offsetting positions" does not include stock or a debt instrument held by a taxpayer and an option (which is not part of a larger straddle) that is a call and is written by the taxpayer, where the exercise price is at least 85 percent of the fair market value of the stock or debt instrument held by the taxpayer at the time the option is written, nor shall such term include a short position in stock or in a debt instrument entered into by a taxpayer and an option (which is not part of a larger straddle) that is a put and is written by the taxpayer, where the fair market value of the stock or debt instrument (which is the subject of the short position) is at ~~least 85~~ percent of the exercise price of the option at the time the option is written.

(3) Presumption. --

(A) In general. -- For purposes of paragraph (2), 2 or more positions shall be presumed to be offsetting if --

(i) the positions are in the same personal property (whether established in such property or a contract for such property),

(ii) the positions are in the same personal property, even though such property may be in a substantially altered form,

(iii) the positions are in debt instruments of a similar maturity or other debt instruments described in regulations prescribed by the Secretary,

(iv) the positions are sold or marketed as offsetting positions (whether or not such positions are called a straddle, spread, butterfly, or any similar name),

(v) the aggregate margin requirement for such positions is lower than the sum of the margin requirements for each such position (if held separately), or

(vi) there are such other factors (or satisfaction of subjective or objective tests) as the Secretary may by regulations prescribe as indicating that such positions are offsetting.

For purposes of the preceding sentence, 2 or more positions shall be treated as described in clause (i), (ii), (iii), or (vi) only if the value of 1 or more of such positions ordinarily varies inversely with the value of 1 or more other such positions.

(B) Presumption may be rebutted. -- Any presumption established pursuant to subparagraph (A) may be rebutted.

(d) Definitions and Special Rules. -- For purposes of this section --

(1) Personal property. -- The term "personal property" means any personal property ~~(other than stock)~~ of a type which is actively traded.

(2) Position. --

(A) In general. -- The term "position" means an interest (including a futures or forward contract or option) in personal property.

~~(B) Special rule for stock options. The term "position" includes any stock option which is part of a straddle and which is an option to buy or sell stock which is actively traded, but does not include a stock option which --~~

~~(i) is traded on a domestic exchange or on a similar foreign exchange designated by the Secretary, and~~

~~(ii) is of a type with respect to which the maximum period during which such option may be exercised is less than the minimum period for which a capital asset must be held for gain to be treated as long-term capital gain under section 1222(3).~~

(B) Special rule for stock. -- The term "position" does not include an interest in stock (or a short position in stock) unless such stock (or a short position in stock) is offset by an option to buy or sell such stock.

(3) Positions held by related persons, etc. --

(A) In general. -- In determining whether 2 or more positions are offsetting, the taxpayer shall be treated as holding any position held by a related person.

(B) Related person. -- For purposes of subparagraph (A), a person is a related person to the taxpayer if with respect to any period during which a position is held by such person, such person --

(i) is the spouse of the taxpayer, or

(ii) files a consolidated return (within the meaning of section 1501) with the taxpayer for any taxable year which includes a portion of such period.

(C) Certain flowthrough entities. -- If part or all of the gain or loss with respect to a position held by a partnership, trust, or other entity would properly be taken into account for purposes of this chapter by a taxpayer, then, except to the extent otherwise provided in regulations, such position shall be treated as held by the taxpayer.

(4) Special rule for regulated futures contracts. -- In the case of a straddle at least 1 (but not all) of the positions of which are regulated futures contracts, the provisions of this section shall apply to any regulated futures contract and any other position making up such straddle.

(5) Regulated futures contract. -- The term "regulated futures contract" has the same meaning given such term by section 1256(b).

(e) Exception for Hedging Transactions. -- This section shall not apply in the case of any hedging transaction (as defined in section 1256(e)).

(f) Cross reference. --

For provision requiring capitalization of certain interest and carrying charges where there is a straddle, see section 263(g).

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EXHIBIT B

SEC. 1256. REGULATED FUTURES CONTRACTS MARKED TO MARKET.

(a) General Rule. -- For purposes of this subtitle --

(1) each regulated futures contract held by the taxpayer at the close of the taxable year shall be treated as sold for its fair market value on the last business day of such taxable year (and any gain or loss shall be taken into account for the taxable year),

(2) proper adjustment shall be made in the amount of any gain or loss subsequently realized for gain or loss taken into account by reason of paragraph (1),

(3) any gain or loss with respect to a regulated futures contract shall be treated as --

(A) short-term capital gain or loss, to the extent of 40 percent of such gain or loss, and

(B) long-term capital gain or loss, to the extent of 60 percent of such gain or loss, and

(4) if all the offsetting positions making up any straddle consist of regulated futures contracts to which this section applies (and such straddle is not part of a larger straddle), sections 1092 and 263(g) shall not apply with respect to such straddle.

(b) Regulated Futures Contracts Defined. -- For purposes of this section, the term "regulated futures contract" means a contract --

(1) with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market; and

(2) which is traded on or subject to the rules of a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission or of any board of trade or exchange which the Secretary determines has rules adequate to carry out the purposes of this section.

Such term includes any foreign currency contract, and any listed option contract held or written by a taxpayer with respect to whom the election in subsection (i) is in effect.

(c) Terminations, Etc. --

(1) In general. -- The rules of paragraphs (1), (2), and (3) of subsection (a) shall also apply to the termination (or transfer) during the taxable year of the taxpayer's obligation (or rights) with respect to a regulated futures contract by offsetting, by taking or making delivery, by exercise or being exercised, by assignment or being assigned, by lapse, or otherwise.

(2) Special rule where taxpayer takes delivery on or exercises part of straddle. -- If --

(A) 2 or more regulated futures contracts are part of a straddle (as defined in section 1092(c)), and

(B) the taxpayer takes delivery under or exercises any of such contracts,

then, for purposes of this section, each of the other such contracts shall be treated as terminated on the day on which the taxpayer took delivery.

(3) Fair market value taken into account. -- For purposes of this subsection, fair market value at the time of the termination (or transfer) shall be taken into account.

(d) Elections With Respect to Mixed Straddles. --

(1) Election. -- The taxpayer may elect to have this section not to apply to all regulated futures contracts which are part of a mixed straddle.

(2) Time and Manner. -- An election under paragraph (1) shall be made at such time and in such manner as the Secretary may by regulations prescribe.

(3) Election revocable only with consent. -- An election under paragraph (1) shall apply to the taxpayer's taxable year for which made and to all subsequent taxable years, unless the Secretary consents to a revocation of such election.

(4) Mixed straddle. -- For purposes of this subsection, the term "mixed straddle" means any straddle (as defined in section 1092(c)) --

(A) at least 1 (but not all) of the positions of which are regulated futures contracts, and

(B) with respect to which each position forming part of such straddle is clearly identified, before the close of the day on which the first regulated futures contract forming part of the straddle is acquired, as being part of such straddle.

(e) Mark to Market Not to Apply to Hedging Transactions. --

(1) Section not to apply. -- Subsection (a) shall not apply in the case of a hedging transaction.

(2) Definition of hedging transaction. -- For purposes of this subsection, the term "hedging transaction" means any transaction if --

(A) such transaction is entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily --

(i) to reduce risk of price change or currency fluctuations with respect to property which is held or to be held by the taxpayer, or

(ii) to reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer,

(B) the gain or loss on such transactions is treated as ordinary income or loss, and

(C) before the close of the day on which such transaction was entered into, the taxpayer clearly identifies such transaction as being a hedging transaction.

(3) Special rule for syndicates. --

(A) In general. -- Notwithstanding paragraph (2), the term "hedging transaction" shall not include any transaction entered into by or for a syndicate.

(B) Syndicate defined. -- For purposes of subparagraph (A), the term "syndicate" means any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs (within the meaning of section 464(e)(2)).

(C) Holdings attributable to active management. -- For purposes of subparagraph (B), an interest in an entity shall not be treated as held by a limited partner or a limited entrepreneur (within the meaning of section 464(e)(2)) --

(i) for any period if during such period such interest is held by an individual who actively participates at all times during such period in the management of such entity,

(ii) for any period if during such period such interest is held by the spouse, children, grandchildren, and parents of an individual who actively participates at all times during such period in the management of such entity,

(iii) if such interest is held by an individual who actively participated in the management of such entity for a period of not less than 5 years,

(iv) if such interest is held by the estate of an individual who actively participated in the management of such entity or is held by the estate of an individual if with respect to such individual such interest was at any time described in clause (ii), or

(v) if the Secretary determines (by regulations or otherwise) that such interest should be treated as held by an individual who actively participates in the management of such entity, and that such entity and such interest are not used (or to be used) for tax-avoidance purposes.

For purposes of this subparagraph, a legally adopted child of an individual shall be treated as a child of such individual by blood.

(4) Special rule for banks. -- In the case of a bank (as defined in section 581), subparagraph (A) of paragraph (2) shall be applied without regard to clause (i) or (ii) thereof.

(f) Special Rules. --

(1) Denial of capital gains treatment for property identified as part of a hedging transaction. -- For purposes of this title, gain from any property shall in no event be considered as gain from the sale or exchange of a capital asset if such property was at any time personal property (as defined in section 1092(d)(1)) identified under subsection (e)(2)(C) by the taxpayer as being part of a hedging transaction.

(2) Subsection (a)(3) not to apply to ordinary income property. -- Paragraph (3) of subsection (a) shall not apply to any gain or loss which, but for such paragraph, would be ordinary income or loss. For purposes of this title, gain or loss from the trading of regulated futures contracts (whether or not such trading is in the ordinary course of the taxpayer's trade or business of trading regulated futures contracts) shall be considered gain or loss from the sale or exchange of a capital asset except to the extent the regulated futures contract is held for the purpose of hedging property that is ordinary income or loss property in the hands of the taxpayer. In no case shall property underlying a regulated futures contract be considered to be ordinary income or loss property in the hands of the taxpayer solely by reason of the fact that the taxpayer is in the trade or business of trading regulated futures contracts.

(g) Foreign Currency Contract Defined. --

(1) Foreign currency contract. -- For purposes of this section, the term "foreign currency contract" means a contract --

(A) which requires delivery of a foreign currency which is a currency in which positions are also traded through regulated futures contracts,

(B) which is traded in the interbank market, and

(C) which is entered into at arm's length at a price determined by reference to the price in the interbank market.

(2) Regulations. -- The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of paragraph (1), including regulations excluding from the application of paragraph (1) any contract (or type of contract) if its application thereto would be inconsistent with such purposes.

(h) Listed Option Contract Defined. -- For purposes of this section, the term "listed option contract" means any option (other than any right to acquire stock from an issuer) which is traded on a domestic exchange, a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or a similar foreign exchange or foreign board of trade which the Secretary determines has rules adequate to carry out the purposes of this section.

(i) Elections With Respect to Listed Option Contracts. --

(1) Election. -- The taxpayer may elect to have this section apply to all listed option contracts.

(2) Time and manner. -- An election under paragraph (1) shall be made by attaching a statement to a timely filed tax return for the first taxable year for which the election is to be effective.

(3) Election revocable only with consent. -- An election under paragraph (1) shall apply to the taxpayer's taxable year for which made and to all subsequent taxable years, unless the Secretary consents to a revocation of such election.

(4) Effect of Election. -- An election under this subsection shall not affect the determination of whether a taxpayer is engaged in the trade or business of trad-

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EXHIBIT C

SEC. 1234. OPTIONS TO BUY OR SELL.

(a) Treatment of Gain or Loss in the Case of the Purchaser. --

(1) General rule. -- Gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, an option to buy or sell property shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him).

(2) Special rule for loss attributable to failure to exercise option. -- For purposes of paragraph (1), if loss is attributable to failure to exercise an option, the option shall be deemed to have been sold or exchanged on the day it expired.

(3) Nonapplication of subsection. -- This subsection shall not apply to --

(A) an option which constitutes property described in paragraph (1) of section 1221;

(B) in the case of gain attributable to the sale or exchange of an option, any income derived in connection with such option which, without regard to this subsection, is treated as other than gain from the sale or exchange of a capital asset; and

(C) a loss attributable to failure to exercise an option described in section 1233(c).

(b) Treatment of Grantor of Option in the Case of Stock, Securities, or Commodities. --

(1) General rule. -- In the case of the grantor of the option, gain or loss from any closing transaction with respect to, and gain on lapse of, an option in property shall be treated as a gain or loss from the sale or exchange of a capital asset held not more than 1 year.

(2) Definitions. -- For purposes of this subsection --

(A) Closing transaction. -- The term "closing transaction" means any termination of the taxpayer's obligation under an option in property other than through the exercise or lapse of the option.

ing the underlying property, or is a dealer in the underlying property for purposes of section 1091.

(B) Property. -- The term "property" means stocks and securities (including stocks and securities dealt with on a "when issued" basis), commodities, and commodity futures.

(3) Nonapplication of subsection. -- This subsection shall not apply to any option granted in the ordinary course of the taxpayer's trade or business of granting options.

(c) Treatment of Gain or Loss in the Case of a Cash Settlement Option and a Commodity Option. --

(1) General rule. -- In the case of the grantor or purchaser of a cash settlement option or commodity option, gain or loss attributable to the sale, exchange, lapse, exercise, or failure to exercise shall be treated as gain or loss from the sale or exchange of a capital asset held not more than one year.

(2) Cash settlement option defined. -- For purposes of this section, the term "cash settlement option" means any option (which is traded on a domestic exchange) which settles in (or could be settled in) cash or property other than the underlying property on exercise.

(3) Commodity option defined. -- For purposes of this section, the term "commodity option" means any option (which is traded on or subject to the rules of a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission) where the underlying property is a regulated futures contract (as defined in section 1256(b)).

(4) Nonapplication of subsection. -- This subsection shall not apply to an option which constitutes property described in paragraph (1) of section 1221 or to any option acquired or granted in the ordinary course of the taxpayer's trade or business of acquiring and granting options.

(d) [Repealed]

EXHIBIT D

SEC. 1236. DEALERS IN SECURITIES

(a) Capital Gains. -- Gain by a dealer in securities from the sale or exchange of any security shall in no event be considered as gain from the sale or exchange of a capital asset unless --

(1) the security was, before the close of the day on which it was acquired (before the close of the following day in the case of an acquisition before January 1, 1982), clearly identified in the dealer's records as a security held for investment or if acquired before October 20, 1951, was so identified before November 20, 1951; and

(2) the security was not, at any time after the close of such day, held by such dealer primarily for sale to customers in the ordinary course of his trade or business.

(b) Ordinary Losses. -- Loss by a dealer in securities from the sale or exchange of any security shall, except as otherwise provided in section 582(c)(relating to bond, etc., losses of banks), in no event be considered as ordinary loss if at any time after November 19, 1951, the security was clearly identified in the dealer's records as a security held for investment.

(c) Definition of Security. -- For purposes of this section, the term "security" means any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.

(d) Special Rule for Floor Specialists. --

(1) In general. -- In the case of a floor specialist (but only with respect to acquisitions, in connection with his duties on an exchange, of stock in which the specialist is registered with the exchange), subsection (a) shall be applied --

(A) by inserting "the 7th business day following" before "the day" the first place it appears in paragraph (1) and by inserting "7th business" before "day" in paragraph (2), and

(B) by striking the parenthetical phrase in paragraph (1).

(2) Floor specialist. -- the term "floor specialist" means a person who is --

(A) a member of a national securities exchange,
(B) is registered as a specialist with the exchange, and
(C) meets the requirements for specialists established by the Securities and Exchange Commission.

(e) Special Rule for Options. -- For purposes of subsection (a), any security acquired by a dealer pursuant to an option held by such dealer may be treated as held for investment only if the dealer, before the close of the day on which the option was acquired, clearly identified the option on his records as held for investment. For purposes of the preceding sentence, the term "option" includes the right to subscribe to or purchase any security.

(f) Coordination with 1256. -- This section shall not apply to a taxpayer for whom the election in section 1256(i) is in effect with respect to listed option contracts (as defined in section 1256(h)).

EXHIBIT E

SEC. 263(g).

(g) Certain Interest and Carry Costs in the Case of Straddles --

(1) General rule. -- No deduction shall be allowed for interest and carrying charges properly allocable to personal property which is part of a straddle (as defined in section 1092(c)). Any amount not allowed as a deduction by reason of the preceding sentence shall be chargeable to the capital account with respect to the personal property to which such amount relates.

(2) Interest and carrying charges defined. -- For purposes of paragraph (1), the term "interest and carrying charges" means the excess of --

(A) the sum of --

(i) interest on indebtedness incurred or continued to purchase or carry the personal property, and

(ii) all other amounts (including charges for temporary use of the personal property in a short sale, or to insure, store, or transport the personal property) paid or incurred to carry the personal property, over

(B) the sum of --

(i) the amount of interest (including original discount) dividends and all other amounts includible in gross income for the taxable year with respect to the property described in subparagraph (A), and

(ii) any amount treated as ordinary income under section 1232(a)(3)(A) with respect to such property for the taxable year.

(3) Exceptions for hedging transactions. -- This subsection shall not apply in the case of any hedging transaction (as defined in section 1256(e)).

COVERED CALL WRITING IN OPTIONS ON DEBT SECURITIES: A DESCRIPTION AND IDENTIFICATION OF TAX ISSUES

I. Nature and Objectives of Covered Call Writing

The options markets provide a remarkable variety of possibilities for limiting the risks and/or enhancing returns on investments in (or with respect to) the underlying security. Some of these investment strategies employ option positions on a stand-alone basis while others involve combining an options position with a position in the underlying security.

The most widely employed combination strategy, by far, is known as covered call writing. The covered call writer's modus operandi is to sell (write) call options on his holdings of the underlying security. The two positions may be established in conjunction or the call may be sold on an existing position in the underlying security. By writing the call, the investor foregoes profit opportunity on his underlying security position in the event of a substantial increase in its market value during the term of the option. In return, the premium received on the call written serves to enhance the investor's returns in the event of a stable market for the underlying security and to provide a cushion against any underlying security losses incurred in the event of a substantial market decline.

Different approaches can be taken to covered call writing that give differing emphasis to the return enhancement or risk reduction objectives, but some element of both is usually present. In no case, however, does the premium received for writing the call offset more than a fraction of the downside risk associated with a long position in the underlying security.

For options on debt securities, covered call writing strategies can be expected to adhere to the patterns of the equity options market. Most commonly, these involve writing call options at an exercise price approximating the market price of the underlying security at the time the call is written. Such options are known as "at-the-money" options to distinguish them from "in-the-money" options (where the market price exceeds the exercise price) and "out-of-the-money" (where the exercise price exceeds the market price).

II. Analysis of a Single Writing Transaction

Assume that Treasury 14s of 2011 are the underlying security for a Treasury bond options contract on the CBOE. With Treasury 14s trading at par in March, the CBOE is providing a market in options with exercise prices of 95, 100 and 105 expiring in June, September and December. Against the purchase of $100,000 (par) Treasury 14s, September 100 options are written for a premium of 4 points. Table 1 below compares covered call writing returns with underlying security returns for the six month holding period to the option's expiration under various assumptions as to the bond's price movement over the term of the option. Along with underlying security price movement, the other factors that must be taken into account in this comparison are interest income on the bond and the premium received for writing the call.[1] The comparison of returns to expiration (expressed in dollars) on the $100,000 investment involved is as follows:

Table 1

COMPARISON OF UNDERLYING SECURITY
AND COVERED CALL WRITING RETURNS

Bond Price at Option Expiration	Gain (Loss) on Bond Position	Six Months Bond Interest	STAND-ALONE BOND RETURNS	Option Premium	COVERED CALL RETURNS
80	$ (20,000)	$ 7,000	$ (13,000)	$ 4,000	$ (9,000)
85	(15,000)	7,000	(8,000)	4,000	(5,000)
90	(10,000)	7,000	(3,000)	4,000	1,000
95	(5,000)	7,000	2,000	4,000	6,000
100	0	7,000	7,000	4,000	11,000
105	5,000	7,000	12,000	4,000	11,000
110	10,000	7,000	17,000	4,000	11,000
115	15,000	7,000	22,000	4,000	11,000
120	20,000	7,000	27,000	4,000	11,000

---

[1] In the interest of simplicity, the comparison does not take into account such relatively minor factors as transaction costs and interest income on the positive cash flow generated by writing the call.

The above example brings out clearly the stabilizing influence that covered call writing can have upon investment returns as compared to investing in the underlying security alone. The lower returns from covered call writing in the event of a substantial bond price increase represent an opportunity cost that is accepted in advance by covered call writers in order to achieve enhanced returns in a stable or declining market. This ability to stabilize returns on bond investments (over one or a succession of option writing periods) takes on much greater importance as an investment technique when considered against a backdrop of heightened bond market volatility that has greatly accentuated the risks of investing in debt securities.

The table also makes it clear that covered call writing, while reducing investment risks and stabilizing returns, by no means eliminates the risks associated with the bond position covering the call written. The covered call writer remains exposed to losses on his bond position in the event of a bond market decline. He accepts this risk in return for the prospect of enhanced as well as stabilized returns over a succession of option writing periods. (If elimination of risk, for any reason, were his objective, the sale of a futures contract or the purchase of a put option represent the investment strategies that would provide outright protection against a decline in the bond market).

When a covered call writing position is established as a one-time undertaking, the tax consequences of the transactions seem clear and reasonable enough. The two contingencies that need to be covered are (1) the case in which the price of the underlying security has risen above the option exercise price and the security is called away; and (2) the case in which the price of the underlying security at the option's expiration is at or below the exercise price, in which event the option lapses worthless and the underlying security position is sold on the open market. Tax consequences in each of these cases can be addressed by way of examples that draw upon the assumptions used in our Treasury bond covered writing transaction discussed above.

Case 1

Option Exercise

With Treasury 14s trading at 110 in September, our covered writer can expect to be exercised on the September 100 options he wrote in March. Upon exercise, the 4 point option premium received is added to the exercise (sale) price of 100 for the Treasury 14s, producing a 4 point short-term capital gain on the bonds that were purchased in March as option cover.

Case 2

Option Lapse

With Treasury 14s trading at 90 in September, the September 100 option written expires worthless. Section 1234 provides for short-term capital gain treatment of the 4 point premium received upon expiration of the option (regardless of its term). This short-term gain is coupled with a 10 point short-term capital loss upon sale of the Treasury 14 position established to cover the option written.

III. Transactions involved in an ongoing writing program

The trouble with examples that focus on single writing commitments is that most covered call writers do not take a one-time approach but rather pursue this investment strategy on an ongoing basis. A succession of options are written for successive expirations that may cumulatively extend over a period of years in the interest of achieving of systematic, long-term stabilization and enhancement of bond investment returns. If each successive writing commitment were concluded by an option exercise or lapse (as in the examples above), tax treatment would continue to be relatively clear. But such is not the case.

For reasons that will be explained below, it is generally disadvantageous for investors engaged in systematic covered call writing to allow each option written to be exercised (if in-the-money) or to close out covering bond positions upon lapse of an out-of-the-money option. Instead, the preferred method of conducting a covered call writing program over time is to maintain the underlying security position against which the calls are written and to effect a succession of rolling transactions in the options market that change the options written both in relation to expirations and underlying security price movements. Such options rolling transactions are known as roll-forwards (from a near-by expiration month to a deferred one), roll-ups (from a lower exercise price to a higher one) and roll-downs (from a higher exercise price to a lower one). The following examples will serve to illustrate how each type of rolling transaction works and how it contributes to the achievement of covered call writing objectives.

Roll - Forwards

When an in-the-money call is exercised, a covered call writer whose objectives are to continue writing over time is faced with transactions costs to re-establish his covering positions (and in many cases with charges on the exercise transaction as well). Writers can avoid these costs by acting, prior to exercise, to close out their writer position in the options market through what are known as closing purchase transactions while at the same time establishing new writer positions in more distant expiration months.

EXAMPLE: With Treasury 14s trading at 102 just prior to the September option expiration, September 100 calls (having little or no remaining time value) can be expected to be trading on the CBOE for just about their 2 point in-the-money value. The writer position that was established in March at a price of 4 can be closed out at this point for a 2 point gain through a closing purchase transaction accompanied by the writing of, say, a December 100 option for a premium of 4.

Roll - Ups

When the price of the underlying security rises significantly above the exercise price of the option written, the option may be trading for little more than its in-the-money value even when there is considerable time remaining until the option's expiration. In such cases, a covered call writer can take in more time premium (as distinguished from the in-the-money component of an option's premium) for the same expiration period by closing out the original option written and concurrently writing one at a higher exercise price that still contains time value.

EXAMPLE: After a writer position is established in March in September 100 calls, the bond market rallies so that by June, with covering Treasury 14s trading at 110, the September 100 calls are trading for 10 1/2 --- only 1/2 point more than their in-the-money value. At the same time, September 110 calls, which have been introduced for trading as a result of the rally, can be sold (written) for 3 points --- all of which constitutes additional time premium that the covered call writer can collect for the holding period to September. As with a roll-forward, this roll up can be effected by entering an order to Buy Sept 100s and Sell (Write) Sept 110s. Unlike a roll-forward at the same exercise price, however, the close out of the original writer position on a roll-up generally results in a loss when the option position is viewed in isolation. In this case, a close out at 10 1/2 of the Sept 100 that was originally established at 4 produces an option market loss of 6 1/2 points. (This loss is, of course, more than counterbalanced by the 10 point appreciation in the value of the Treasury 14s held as cover.)

It is also important to bear in mind that writer positions are often rolled both forward and up via a single transaction. Instead of rolling from Sept 100s to Sept 110s, as in the above example, our covered writer might well have elected to roll to Dec 110s. Indeed, whenever writer positions are rolled forward following a market rally, the new writer position can be expected to be established at a higher exercise price than the old one being closed. In most such cases, the close out will produce an option market loss of the sort illustrated above.

Roll - Downs

In a declining market, covered call writers often elect to roll down their option positions from a higher exercise price to a lower exercise price. The impetus for such roll downs is typically the loss of most (or nearly all) of the original writing position's market value after the option has moved substantially out of the money. As with roll-ups, such roll-downs are often accompanied by roll-forwards. Once again, the objective is generally to capture the additional time premium that can be obtained by writing an option with an exercise price approximating the market price of the underlying security at the time the writer position is rolled down.

EXAMPLE: As the September option expiration approaches, Treasury 14s are trading at 96. The September 100 call option originally sold (written) for 4 points now has a minimal remaining market value of 1/8th. At the same time, the CBOE is providing a market in both December 100s, which are priced at 1, and December 95s, which are priced at 3. Our covered call writer's objectives are to continue the writing program, obtaining as much time value as possible for extending his writing commitment to December. Thus, he elects to roll down and forward in conjunction by closing out his September 100 writer position at 1/8th, and concurrently writing a December 95 at 3. The writer's option market gain of 3 7/8 on closing September 100 position is, of course, counterbalanced by a 4 point loss (unrealized) on his position in Treasury 14s.

IV. Tax Implications of Ongoing Writing Program

Over a succession of option writing periods, both gains and losses can be expected on the options positions that are closed out as the writer rolls his positions forward, up and down. The table below is illustrative of the cumulative mix of options gains and losses that might be realized over a two-year period -- during which it is assumed that the Treasury 14 position established at the outset continues to serve as cover for all successive options written. Any evaluation of total investment returns from the covered call writing program must also take into account appreciation or decline in the value of the underlying securities, and the table shows these unrealized gains and losses as well (as of the dates that each successive call writing position is closed out). The table assumes the purchase of $100,000 Treasury 14s in March, 1982, against which the following call writing and close out transactions are effected (all such trades are assumed to be for options on $100,000 par amount of Treasury 14s):

Table 2

ILLUSTRATION OF OPTION GAINS AND LOSSES
RESULTING FROM A COVERED CALL WRITING PROGRAM OVER TIME

Date	Price of Treasury 14s	Unrealized Gain (Loss) in Treasury 14s	Option Transactions	Option Premium Credits (Debits)	Realized Option Gains (Losses)
Mar 82	100	$	Write Sept 100 calls @ 4	$ 4,000	$ -
June 82	110	10,000	Close Sept 100 calls @ 10 1/2	(10,500)	(6,500)
			Write Dec 110 calls @ 4	4,000	-
Dec 82	109	9,000	Dec 110 calls lapse	0	4,000
			Write June 110 calls @ 4	4,000	-
12/31/82	109	9,000			
Mar 83	105	5,000	Close June 110 calls @ 1/2	(500)	3,500
			Write June 105 calls @ 3	3,000	-
June 83	98	(2,000)	June 105 calls lapse	0	3,000
			Write Dec 100 calls @ 3	3,000	
Nov 83	106	6,000	Close Dec 100 calls @ 6	(6,000)	(3,000)
			Write Mar 105 calls @ 4	4,000	
12/31/83	103	3,000			
Mar 84	96	(4,000)	Mar 105 calls lapse	0	4,000
			Aggregate Gains (Losses) on option writing transactions		5,000

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October 28, 1983

The Honorable John E. Chapoton
Assistant Secretary (Tax Policy)
United States Department of the Treasury
Room 3112
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Supplemental Memorandum Regarding Competition Between Futures and Options

Dear Mr. Chapoton:

On behalf of the Chicago Board Options Exchange, Inc. (the "CBOE"), enclosed is a memorandum regarding the present competition between futures and options on financial instruments. This memorandum supplements the CBOE's legislative proposal for the taxation of listed option contracts which we submitted to you on August 15, 1983. We believe the memorandum clearly illustrates that futures and options are viewed in the public markets as functionally equivalent and competing financial products.

The CBOE would like to take this opportunity to inform you that the CBOE now supports mandatory, non-elective mark to market and 60/40 tax treatment for listed option contracts. In the event that the Treasury Department has reservations about the exemption for covered calls that is presently in the CBOE proposal, the CBOE is willing to work with the Treasury and the Congressional Committee staffs to develop an acceptable exemption. We believe that an exemption for legitimate covered call transactions can be structured to both satisfy any concerns of the Treasury Department and meet the needs of the public markets.

Finally, the CBOE would like again to express its previously stated position that commodity options are not regulated futures contracts under the present law. The CBOE believes that the U.S. Treasury Department should not support an amendment to Section 1256 which would change that result without resolving the broader tax policy issues addressed in the CBOE's legislative proposal.

Sincerely,

Samuel C Thompson Jr.
Samuel C. Thompson, Jr.

SCT:er
Enc.

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MEMORANDUM FOR THE UNITED STATES
DEPARTMENT OF THE TREASURY

COMPETITION BETWEEN FUTURES AND OPTIONS ON FINANCIAL INSTRUMENTS SUPPLEMENTING THE

LEGISLATIVE PROPOSAL FOR TAXATION OF LISTED OPTION CONTRACTS

Submitted on behalf of the
Chicago Board Options Exchange, Inc.

Samuel C. Thompson, Jr. and
Carl A. Royal
Counsel for the
Chicago Board Options
Exchange, Inc.

October 28, 1983

This Memorandum is intended to supplement the Memorandum dated August 15, 1983 ("August Memorandum") that was submitted to the United States Department of the Treasury on behalf of the Chicago Board Options Exchange, Incorporated ("CBOE") regarding CBOE's legislative proposal for taxation of listed option contracts. In the August Memorandum at pages 50-53, it was noted that the significant differences in the tax treatment of commodity futures contracts and securities options were creating economic distortions by causing taxpayers to alter their decisions with respect to essentially comparable investment products. This Memorandum is being submitted in further support of the proposition that futures and options are, in many cases, competing products which serve comparable economic functions, and hence that it is in the public interest to eliminate the tax disparities between futures and options.

Both futures and options serve comparable economic functions.

A futures contract has been defined by the Commodity Futures Trading Commission ("CFTC") as "a firm commitment to deliver or to receive a specified quantity and grade of a commodity during a designated month with price being determined by public auction among exchange members."* An option is a contract giving the holder the right, but not the obligation, to buy (a "call option") or to sell (a "put option") a specified amount of the underlying asset at a specified price within a specified period of time. As can be seen from these definitions, futures and options are both derivative instruments in the sense that their prices depend on the perceived value of the underlying asset within a specified time period.

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* S. Rep. No. 850, 95th Cong., 2d Sess. 128 (1978).

Both futures and options provide means of transferring the risk of future price changes. Thus, both futures and options provide investors with similar risk management opportunities ranging from leveraged investments of relatively high risk to hedged investments of relatively low risk. As noted by Harold M. Williams, former Chairman of the Securities and Exchange Commission ("SEC"), persons desiring to speculate on the future price movements of the underlying asset can do so by using the leverage inherent in either futures or options:

> By using financial futures or securities options, investors can pursue a high-risk investment strategy. They can pay a relatively small amount of money -- a margin for a future, or a premium for an option -- in return for the opportunity of reaping a proportionately large profit or suffering a proportionately large loss.*

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* Prepared Statement of Harold M. Williams, Chairman, SEC, in Extend Commodity Exchange Act: Hearings on H.R. 10285 Before the House Subcommittee on Conservation and Credit, 95th Cong., 2d Sess. 181, 193 (1978).

Futures contracts and options can also be used in furtherance of more conservative investment strategies. For example, an institutional investor holding a long position in U.S. Treasury bonds may wish to hedge its position against an expected short-term price decline without actually selling the bonds. The investor could establish such a hedge by using either futures or options. By selling Treasury bond futures or by purchasing put options on Treasury bonds, the investor could offset any loss in its bond position with corresponding gain in its futures or options position.

This is not to say that futures and options are identical. One who buys or sells an unhedged futures contract has virtually unlimited profit potential and loss potential. In contrast, the risk/reward characteristics are allocated differently in options transactions, including options on futures ("commodity options") prior to exercise. The purchaser of an option has virtually unlimited profit potential, but his maximum loss is limited to the premium paid to purchase the option. On the other hand, the maximum profit of the option writer (seller) is the premium received from the option buyer, while the option writer has virtually unlimited loss exposure. However, these differences between futures and options can, in many circumstances, be eliminated by certain trading strategies. For example, the writer of an uncovered call option, by applying the premium received to the purchase of a put option on the same underlying asset, can essentially replicate the risk/reward characteristics of an uncovered short futures position.* Thus, as a practical matter, the economic functions served by futures and options are essentially comparable.

Competition between futures and options.

Ten years ago there was virtually no connection between the commodities (primarily agricultural products and metals) underlying futures contracts traded on boards of trade and the securities (common stocks) underlying options traded on national securities exchanges. However, during the past decade, both the commodities exchanges and the securities exchanges have developed a host of new trading instruments that are in direct competition with each other. For example, there are now both commodity futures contracts and securities options contracts based on U.S. Treasury securities, stock indices and foreign currencies.** This direct competition between the commodities exchanges and the securities exchanges has been further increased by the introduction of commodity options.

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* See Letter from SEC Commissioner Irving M. Pollack, dated February 19, 1980, to CFTC Chairman James Stone, reprinted in, Silver Prices and the Adequacy of Federal Actions in the Marketplace, 1979-80: Hearings Before a Subcommittee of the House Committee on Government Operations, 96th Cong. 2d Sess. 67, 69 (1980).

** See H.R. Rep. No. 565, 97th Cong. 2d Sess. Part 2 at 5-6 (1982).

Because options and futures contracts are now based on the same financial instruments, they have increasingly begun to compete with each other for the same investment dollars. As former SEC Commissioner Stephen J. Friedman observed,

> From the investor's point of view, there is a high degree of substitutability among futures, options, and more conventional speculative investments. Moreover, to an increasing degree, futures and options are being marketed by the same firms to the same customers.*

Former CFTC Chairman James M. Stone expressed a similar view:

> In the last few years, the distinctions between securities and commodities have rapidly eroded. The largest commission firms in commodities are not specialty houses; they are affiliates of the major securities firms. Commodities customers and securities customers are increasingly drawn from the same lists.**

The degree of competition between commodity futures contracts and securities options intensified in 1982 with the introduction of stock index futures contracts on three commodities exchanges, the Chicago Mercantile Exchange ("CME"), the New York Futures Exchange and the Kansas City Board of Trade. Stock index futures contracts have been used extensively by participants in the stock and stock options markets to speculate on stock prices and to hedge stock positions:

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* Testimony of Stephen J. Friedman in SEC/CFTC Jurisdictional Issues and Oversight: Hearings Before the Subcommittee on Telecommunications, Consumer Protection, and Finance and the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, 97th Cong., 2d Sess. 330, 333 (1982).

** Letter from James M. Stone, dated February 23, 1982, to Congressman Ed Jones, reprinted in, CFTC Reauthorization: Hearings on H.R. 5447 Before the Subcommittee on Conservation, Credit, and Rural Development of the House Committee on Agriculture, 97th Cong., 2d Sess. 633, 634 (1982) (footnote omitted).

> With respect to speculation, many stock and stock options market investors who had never participated in the futures markets in the past have become active in the stock index futures markets. Stock market professionals have used the stock index futures markets to hedge risk arbitrage transactions, stock underwriting, and block positioning. In addition, pension funds and other institutions have used the stock index futures markets to hedge their portfolios.*

Of course, stock options are also used to obtain leverage and to hedge stock positions.** Thus, stock index futures are being used by participants in the securities markets to perform many of the same functions that stock options also perform.

In 1983 a number of securities exchanges -- the CBOE, the American Stock Exchange ("AMEX") and the New York Stock Exchange -- commenced trading in options on broad-based stock indices (diversified indices attempting to measure the stock market as a whole). These index options serve the same hedging functions as stock index futures.* In recent months CBOE and AMEX have also begun to trade options on "narrow-based" stock indices -- that is, indices containing stocks from a single industry and attempting to reflect price movements for stocks in that industry only. The line between these index options and individual stock options begins to blur as the indices become narrower. For example, options are traded on an index that is composed of only six oil company stocks, as well as on an index in which the stock of a single issuer (IBM) comprises more than 70% of its entire value.** Indeed, the computer industry indices on which CBOE and AMEX trade options are referred to in the securities industry and the press as "IBM surrogates."***

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* Dr. Frank J. Jones, Senior Vice President, New York Stock Exchange, Inc., "Stock Index Futures and Options" (1983), attached hereto as Exhibit A, at 2.

** See Report of the Special Study of the Options Markets to the Securities and Exchange Commission, 96th Cong., 1st Sess. 106-114, 159-63 (1979).

Applications of certain commodities exchanges to trade futures contracts on narrow-based stock indices are pending or have been approved by the CFTC. The CFTC has approved the CME's application to trade futures on a sub-index of the S&P 500 consisting solely of stocks of companies in the consumer staple industry (e.g., foods, beverages, cosmetics, soap and tobacco). Still pending before the CFTC are applications by the CME to trade futures contracts on four other sub-indices, as well as by the Chicago Board of Trade to trade futures on five narrow-based indices, each composed of ten stocks from the petroleum, information processing, electronics, drug and health care, and chemical industries, respectively.* Accordingly, it appears likely that there will be continuing pressure to trade stock index futures contracts on narrower and narrower stock indices, just as is happening with respect to index options traded on securities exchanges. And, as index options and futures become narrower, they will increasingly become substitutes for and competitive with options on individual stocks.

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* See, e.g., Jones, "Stock Index Futures and Options," Exhibit A hereto at 3-8.

** See Securities Exchange Act Rel. Nos. 20125 and 20178, 48 Fed. Reg. 40046 and 43248 (1983) (approving CBOE's proposals to trade options on the S&P Oil (Integrated International) Industry Index and the S&P Office and Business Equipment Industry Index).

*** See Securities Week, October 3, 1983 at 3.

Need to avoid unequal regulation of competing products.

It is generally agreed that Government regulation ought to be neutral as between two competing products; otherwise, the product subject to more onerous regulation will be at an unfair competitive disadvantage. Because (as shown above) futures and options are competing products which serve comparable economic functions, application of this principle calls for even-handed Government regulation in order to avoid giving one product a competitive advantage over the other. For example, SEC Chairman John S. R. Shad recently expressed concern over regulatory disparities between commodity futures contracts and securities options:

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* See Securities Week, September 26, 1983, at 8. Although Section 2(a)(1)(B)(ii)(III) of the Commodity Exchange Act requires that a stock index futures contract be based on an index which is "a widely published measure of ... the market for all publicly traded equity or debt securities or a substantial segment thereof," or is "comparable to such measure," the CFTC's interpretation of that language is unclear.

> [F]inancial instruments should compete on the basis of relative economic advantages and the quality and efficiency of the markets and services they provide, not on the basis of differences in regulatory requirements. For example, investors should determine whether to trade in futures or options on stock indices based on their investment needs and their evaluation of the relative risks of those instruments, not on the basis of different levels of margin requirements.*

The problem of unequal regulation of futures and options has also been recognized by the Board of Governors of the Federal Reserve System ("Board"), which has proposed to amend its margin regulations in order to establish margin requirements for futures contracts based on stock indices. In its release proposing such amendments, the Board expressly noted the competition that exists between stock index futures and stock options:

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* Prepared statement of John S. R. Shad, Chairman, SEC, in Securities-Commodities Accord Amendments of 1982: Hearings on S. 2260 Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, 97th Cong., 2d Sess. 30, 43 (1982).

> In considering the matter, the Board took into account that stock index futures contracts can, to an important degree, compete with, and be an economic substitute for, stock options, on which margin requirements are currently imposed. In addition to limiting the use of speculative credit, margin requirements, therefore, may be appropriate to assure competitive equality among functionally similar instruments.*

Given the extreme importance of tax consequences to many investment decisions, the need to avoid unequal tax treatment of futures and options is even stronger. The favorable tax treatment that stock index futures contracts receive is prominently mentioned in the sales literature distributed by the commodities exchanges as a reason for investors to participate in their markets.** Therefore, in order to prevent investment decisions from being distorted by unequal tax consequences, it is imperative that the tax disparities between futures and options be eliminated as promptly as possible.

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* Release issued by the Board of Governors of the Federal Reserve System, February 24, 1982, attached hereto as Exhibit B, at 1-2.

** See, e.g., Chicago Mercantile Exchange, "The S&P 100 Stock Index Futures Contract: Flexibility for Today's Investor," attached hereto as Exhibit C, which lists the advantages of stock index futures contracts as including the ability "to speculate on short-term market moves and still receive attractive tax treatment."

STOCK INDEX FUTURES
AND
OPTIONS

Dr. Frank J. Jones
Senior Vice President
New York Stock Exchange, Inc.

July 25, 1983

EXHIBIT A

The new stock index futures and options markets have undoubtedly filled a niche in the stock market world. These stock index futures and options can be used either to increase an investor's stock market risk and exposure in an attempt to increase gains, or to eliminate or remove the risk in an investor's existing stock portfolio - commonly called hedging. In either case, the risk is due to changes in the level of an overall stock market average or index, not changes in the price of an individual stock.

These futures or options contracts, whether being used to increase or reduce risk, are therefore necessary or desirable only when there is substantial stock market risk, that is, only when the level of the overall stock market index is volatile. Thus, price volatility and the use of futures or options naturally go together.

Stock Index Futures Markets

For many years, futures markets were based only on agricultural products. These markets were used by producers and purchasers of agricultural products to hedge the risk of future prices. Later, futures markets in precious metals, particularly gold and silver, were developed after the prices of these metals were allowed to float. Then during 1975, after highly volatile interest rate periods during the summers of 1973 and 1974, interest rate futures were developed, first on GNMAs, and soon thereafter on U.S. Treasury bills and bonds. These financial futures markets, in addition to being used by speculators who had never participated in the futures markets before, have been extensively used for hedging by professionals in the Treasury security markets, particularly U.S. Treasury security dealers. These futures markets have also been used to hedge underwritings of and the portfolio risk of not only Treasury securities, but also corporate and municipal bonds. Interest rate futures now represent an integral part of the U. S. Treasury securities markets as well as the corporate and municipal bond markets.

After the development of futures markets on fixed income securities, the development of futures markets on equity securities seemed a natural next step in the evolution of the futures markets.

Between February and May 1982, futures markets on three different stock market averages, the Value Line Composite Index, the S&P 500 Stock Index, and the NYFE Composite Index, began trading. These three stock index futures contracts are based on broad-based stock market averages or indexes, not on the prices of individual stocks. The specifications of these contracts are shown in Exhibit 1.

These futures contracts have developed more quickly than any futures contracts previously introduced. They now frequently trade more in dollar value on a given day than the dollar value of stocks traded on the New York Stock Exchange, as illustrated in Exhibit 2.

These contracts have been extensively used for speculation and for hedging. With respect to speculation, many stock and stock options market investors who had never participated in the futures markets in the past have become active in the stock index futures markets. Stock market professionals have used the stock index futures markets to hedge risk arbitrage transactions, stock underwriting, and block positioning. In addition, pension funds and other institutions have used the stock index futures markets to hedge their portfolios. The nature of these hedges is discussed below.

Stock Index Options

The next step in the development of the derivative instruments on stock market averages involved options, a device more familiar than futures to many stock market participants. Under the Commodities Futures Trading Commission's pilot program on commodity options, the New York Futures Exchange and the Chicago Mercantile Exchange began trading options on their underlying stock index futures contracts on January 28, 1983.

Somewhat later, on March 11, 1983, the Chicago Board of Options Exchange, under the regulation of the Securities and Exchange Commission, began trading an option on an index of its own construction, the CBOE-100. On April 29, 1983 the American Stock Exchange began trading an option on the Major Market Index (MMI), also an index of its own construction. The New York Stock Exchange will also soon begin trading an option on the NYSE Composite Index. While futures contracts are the deliverable on the CFTC regulated options, the SEC regulated options are settled in cash. The specifications of the options contracts on the commodity and security exchanges are summarized in Exhibit 3.

The difference between the commodities exchange's options on the futures contract on the stock market average and the stock and stock options market on underlying indexes have some important technical differences which are not discussed here.

Overall, both stock market speculators and hedgers have a broad menu of new derivative products from which to select. And there are three attractive features of these derivative products relative to the stock market. The first is leverage. Whereas in the stock market, 50% of the value of the stock market purchase has to be put up by the investor, only approximately 10% of the value of a futures contract has to be put up for stock index futures. On the options contract, it is also small. In addition, the stock index futures and options contracts are very liquid, with trading volume commonly exceeding that of the stock market, as indicated above. Third, the commission per dollar of transaction for stock index futures in options is substantially less than for stocks. It is for these reasons and others that futures and options on stocks indexes have achieved a substantial success in a very short period of time.

Hedging with Stock Index Futures and Options

The remainder of this article describes the differences and behavior of stock index futures and options for hedging.

As indicated above, stock index futures and options can be used to either increase the risk or decrease the risk due to changes in the price of the overall stock market. In the hedge use, stock index futures provide insurance against changes in the price of the stock market. Just as there are different types of life insurance, for example, term and whole life, stock index futures and options provide different types of stock market insurance. These different types of insurance can be described with reference to Exhibit 4, which shows the profit/loss profiles due to stock price changes for a broadly-based stock portfolio, stock index futures, and calls and puts on stock indexes.

Assume an investor has a broadly-diversified stock portfolio and the current level of the NYSE Composite Index is 90. As shown in Exhibit 4-A, if the market increases to 100 the investor will have a profit of 10 and if the market declines to 80 he will have a loss of 10, assuming the investor is long a broadly-based stock portfolio. Obviously, if the investor is short the stock portfolio, the results will be the opposite.

How do investors hedge with stock index futures? Hedging is defined as taking an offsetting position in the futures or options markets as held in the underlying market so that if the price changes, profits or losses in the cash position are offset by losses or profits in the futures or options position. So if an investor were long a stock position, he would take short futures positions.

Exhibit 4-B shows the profit/loss profile for long and short positions. Exhibit 4-B is based on the assumption that the futures price is equal to the level of the stock market index, an assumption which is discussed below. If an investor sells or shorts a futures contract at 90 and the market declines to 80 there will be a profit of 10 on the short futures position offsetting the loss of 10 on the long stock position, and giving a net profit of zero on the combined stock/futures position, as summarized in Exhibit 5.

Contrariwise if the market increases to 100 there is loss of 10 on the short futures position offsetting the profit of 10 on the long stock positions, again giving a net profit of zero. Thus, as illustrated in Exhibit 4-B and summarized in Exhibit 5, a hedge in which a short futures position is used to offset a long stock position nets a profit of zero for all changes, up or down, at any level of the NYSE Composite Index. Thus, the investor is completely insured against losses in his portfolio due to price changes, but the cost of this insurance is any potential gain in his portfolio due to an increase in the price.

This example is simplified to the extent that it is assumes that the futures price is equal to the stock market index itself. In fact, the futures price is typically above the stock market index. That is, if the New York Stock Exchange Composite Index is 90 the NYFE futures price might be 92. However, the basis, or difference between the futures price and the stock market index is variable and sometimes even negative, meaning that the index is above the futures price. Exhibit 6 shows the recent volatility in the basis. If the basis were constant, at zero or any other level, the net profit or loss would be zero on all offsetting cash/futures positions. But with a variable basis, there may be a net profit or loss depending on the change in the basis between the time the short futures position is put on and when it is taken off. The net profit or loss, then, would be only the change in the basis and would typically be small relative to the overall profits and losses on either the stock positions or the futures positions.

Stock portfolios can also be hedged with puts. A put gives the right to the buyer to sell the underlying, at a value equal to the strike price, to the seller of the put. The profit/loss profile of short and long put positions with strike prices of 90 and premiums of 5 are shown in Exhibit 5-C.

To hedge a long stock position, a long put position would be used. The buyer of the put would pay a premium of 5 to hedge his stock portfolio. Thus, if the market declines from 90 he would lose no more than 5, the premium paid on the put, as summarized in Exhibit 5. However at prices of 90 and above, the investor's gain on the portfolio would equal total gain on the portfolio less the 5 paid for the put. Thus, for example, as summarized in Exhibit 5, if the market stayed at 90 the investor would lose 5; if it increased to 95 he would break even; and if the market increased to 100, he would profit by 5. For this type of insurance, the hedger pays a premium, in this case 5, for protection against stock market losses. Overall, then he can lose no more than 5 but gets to keep the appreciation, less, of course, the premium he pays for the put.

Another type of transaction with options that can be conducted in conjunction with the underlying stock portfolio involves buying call options. In order to use a call option to provide price protection, an investor would sell call options. The profit/loss behavior for call options is shown in Exhibit 4-D. When selling call options, the seller receives a fixed premium, in this case, 5, but is liable to deliver the underlying strike price, in this case, 90, if the price of the stock increases above the strike price. As shown in Exhibit 4-D, a long stock/short call position experiences a profit of 5 if the underlying index remains the same or increases. However, if the underlying index declines, there will be a loss on the long stock/short call combination. The magnitude of this loss is unlimited. This strategy, called "covered call writing", thus, is not a very effective type of hedging since there is potentially unlimited loss on the combined transaction. And, in fact, this type of strategy is not considered a hedge, but a way of generating income. But it does have some protection or insurance since the amount of the loss on the stock holding is reduced by the amount of the premium when the index goes down, which, however, does mitigate the extent of the loss.

Exhibit 5 summarizes the profit loss potential of three types of hedge strategies considered here, long stock/short futures, long stock/long put, and long stock/short call. As indicated, the long stock/short futures type of hedge represents the type of insurance where the potential gain in the portfolio is sacrificed to avoid the potential loss. Thus, the potential gain is the cost of insurance. On the long stock/long put type of hedge, a fixed cost of insurance, the premium, is paid to avoid losses in excess of the amount of this premium. But the potential gain is not sacrificed.

Which of these two types of insurance is better? This depends on the fixed cost of the insurance, that is, the premium on the put. With a very low premium, the hedger would probably prefer not to sacrifice the potential gain to avoid the loss, whereas at a very high premium, it might be worth sacrificing the potential gain to avoid the potential loss.

Which is better also depends on the degree of confidence with which the investor thinks the market will go up or down. If he is virtually certain that the market would go down and perceives that there is little chance it will go up, he may be more willing to sacrifice potential gain to avoid the losses, and less concerned about paying a premium so he can still keep the potential gain. Thus, either type of hedge may be preferrable under different circumstances.

As indicated above, the long stock/short call strategy is not typically considered to be a hedge, but a way to earn income from stock portfolio.

Two different ways of limiting stock market risk have been considered. Another obvious way, that of liquidating the stock portfolio, has not been considered. Why would an investor choose either one of these hedge transactions rather than liquidating his stock portfolio? There may be several reasons. One reason may concern taxes. Specifically, at least with respect to futures, the investor could prolong the holding period of his stock in order to get long term capital treatment rather than short term capital treatment. For some types of institutions there might be other regulatory reasons that limit their getting out of stocks and into cash.

There may also be market reasons for not being able to liquidate the stock portfolio, at least very quickly. The futures markets are very liquid and large transactions can be accomplished very quickly. If, for example, an investor was convinced there was going to be a downward adjustment in the market, he might want to reduce his stock holding quickly. This might involve selling a substantial number of shares of a large number of stocks. He might not be able to accomplish this very quickly in the stock market and instead, may reduce his effective position in the market by selling stock index futures or buying puts. Then gradually over time he could liquidate his stock portfolio, at the same time liquidating his short futures or long put positions. In addition to providing a more rapid execution, the commissions on the futures and options markets are lower than the stock market. So this strategy may be a cost effective way to reduce a market position.

Contrariwise, an investor who perceives a rapid increase in the market may choose to buy futures contracts or calls to rapidly increase his market position, and then gradually liquidate those positions as he purchases stocks. These strategies are illustrated in Exhibit 7.

Overview:

Futures markets have been used in many industries for years to hedge against price risk. Individual stock options have also been used for hedging individual stock positions. The advent of new futures and options on broad stock market indexes now provides stock market participants with the opportunity to hedge market risk, that is, the risk due to changes in the prices of the overall stock market.

As discussed above, such hedging can be accomplished in various ways. And despite the newness of these contracts, stock market professionals have used the stock index futures and options market to hedge their stock market positions and transactions to a significant extent. It is interesting to note that these types of strategies are applicable not only to large institutions and stock market professionals, but also to individual investors who have reasonably broad holdings in the stock market.

TABLE OF EXHIBITS

Exhibit	
1	Stock Index Futures Contract Specifications
2	Dollar Value of Trading Comparison: Stock Index Futures Contracts vs. New York Stock Exchange Composite Index
3	Stock Index Options Contract Specifications
4	Profit/Loss Profiles of Stock, Stock Index Futures and Stock Index Options
5	Profit/Loss Results on Stock and Hedged Stock Portfolios
6	Profit/Loss Profiles of Hedged Stock Portfolios
7	Futures and Options: Risk/Profit Potential
8	Market Timing Strategies

Exhibit 1

STOCK INDEX FUTURES CONTRACT SPECIFICATIONS

Futures Exchange	Date Listed	Underlying Index	Type of Index	Level of Index*		Contract Multiplier		Dollar Value of Contract
New York Futures Exchange (NYFE)	May 6, 1982	New York Stock Exchange Composite Index	-Market Value Weighted -All 1500 stocks traded on NYSE	97.74	x	$500	=	$48,870
Chicago Mercantile Exchange (CME)	Apr. 21, 1982	Standard & Poor's 500 Index	-Market Value Weighted -500 stocks	168.89	x	$500	=	$84,445
	July 14, 1983	Standard & Poor's 100	-Market Value Weighted -100 stocks CBOE trades options on	169.21	x	$200	=	$33,842
Kansas City Board of Trade (KCBT)	Feb. 26, 1982	Value Line Composite Index	-Geometric Average -Approximately 1700 stocks	205.70	x	$500	=	$102,850

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* Closing values on July 22, 1983.

EXHIBIT 2

DOLLAR VALUE OF TRADING COMPARISON

Trade Date	CME Futures Volume * S&P Index Value Volume * Index * Cash Conv.	NYFE Futures Volume * NYSE Index Value Volume * Index * Cash Conv.	KC Futures Volume * Value Line Index Value Volume * Index * Cash Conv.	Total Futures Value	NYSE Volume * Estimated Avg. Share Price Volume * Avg. Price
6/8/83	48559 * 161.36 * $500 = $3,917,740,120	22751 * 93.57 * $500 = $1,064,405,535	3114 * 198.58 * $500 = $309,189,060	$5,291,334,715	96,600,000 * $35.00 = $3,381,000,000
6/9/83	46196 * 161.83 * $500 = $3,737,949,300	16755 * 93.85 * $500 = $786,228,380	4017 * 199.03 * $500 = $399,751,760	$4,923,929,440	87,440,000 * $35.00 = $3,060,400,000
6/10/83	30722 * 162.68 * $500 = $2,498,927,500	13428 * 94.45 * $500 = $634,137,300	2506 * 200.56 * $500 = $251,301,680	$3,384,366,480	78,470,000 * $35.00 = $2,746,450,000
6/13/83	40025 * 164.84 * $500 = $3,298,860,500	14320 * 95.62 * $500 = $684,639,200	5100 * 202.35 * $500 = $515,992,500	$4,499,492,200	90,700,000 * $35.00 = $3,174,500,000
6/14/83	43867 * 165.53 * $500 = $3,630,652,255	16874 * 96.01 * $500 = $810,036,370	4212 * 203.38 * $500 = $428,318,280	$4,869,006,905	97,710,000 * $35.00 = $3,419,850,000
6/15/83	41568 * 167.11 * $500 = $3,473,214,240	18170 * 96.84 * $500 = $879,791,400	2993 * 204.71 * $500 = $306,348,515	$4,659,354,155	93,410,000 * $35.00 = $3,269,350,000
6/16/83	46714 * 169.14 * $500 = $3,950,602,980	17860 * 97.94 * $500 = $874,604,200	4019 * 206.72 * $500 = $415,403,840	$5,240,611,020	124,560,000 * $35.00 = $4,359,600,000
6/17/83	30931 * 169.13 * $500 = $2,615,680,015	14933 * 98.00 * $500 = $731,717,000	3027 * 206.66 * $500 = $312,779,910	$3,660,176,925	93,630,000 * $35.00 = $3,277,050,000
6/20/83	35423 * 169.02 * $500 = $2,993,597,730	15795 * 97.96 * $500 = $773,639,100	2818 * 206.42 * $500 = $290,845,780	$4,058,082,610	84,270,000 * $35.00 = $2,949,450,000
6/21/83	35928 * 170.53 * $500 = $3,063,400,920	16554 * 98.71 * $500 = $817,022,670	3347 * 207.39 * $500 = $347,067,165	$4,227,490,755	102,880,000 * $35.00 = $3,600,800,000

hibit 3

STOCK INDEX OPTION CONTRACT SPECIFICATIONS

A) Options on Futures

Exchange	Date Listed	Underlying
NYFE	January 28, 1983	One NYSE Composite Index Futures Contract
CME	January 28, 1983	One S&P 500 Index Futures Contract

B) Stock and Stock Options Exchange (SEC)

Exchange	Date Listed	Underlying Index	Type of Index	Level of Index*		Contract Multiplier		Dollar Value of Contract
Chicago Board Options Exchange (CBOE)	Mar. 11, 1983	Standard & Poor's 100 (formerly CBOE-100)	-Market Value Weighted -100 stocks CBOE crades options on	169.21	x	$100	=	$16,921
	July 1, 1983	Standard & Poor's 500 Index	-Market Value Weighted -500 stocks	168.89	x	$500	=	$84,445
American Stock Exchange (AMEX)	Apr. 29, 1983	Major Market Index	-Simple average of stock prices -20 stocks (15 in DJIA)	120.66	x	$100	=	$12,066
	July 8, 1983	Market Value Index	-Market Value Weighted -800 stocks listed on AMEX	247.62	x	$100	=	$24,762
New York Stock Exchange (NYSE)	Sept. 23, 1983	NYSE Composite Index	-Market Value Weighted -1500 stocks listed on NYSE	97.74	x	$100	=	$ 9,774

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* Closing values on July 22, 1983.

Profit/Loss Profiles of Stock, Stock Index Futures and Stock Index Options

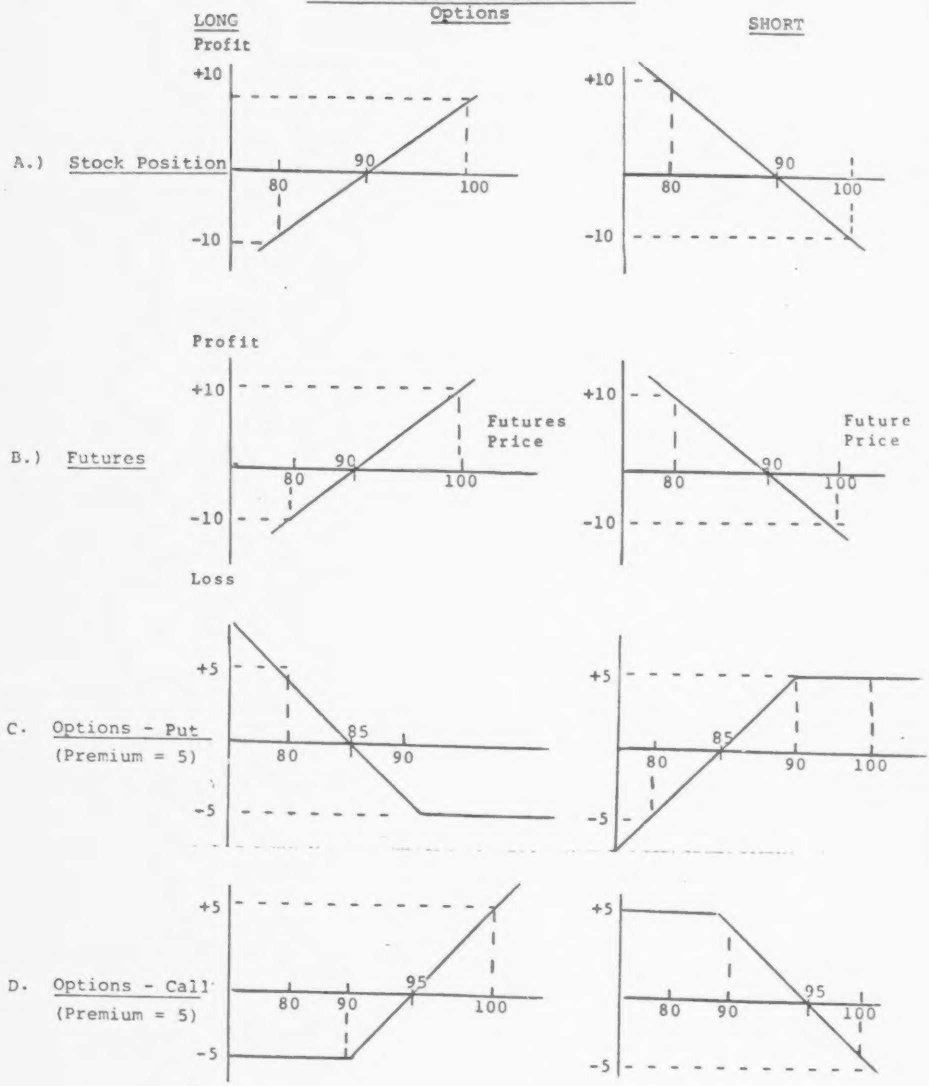


Exhibit 5

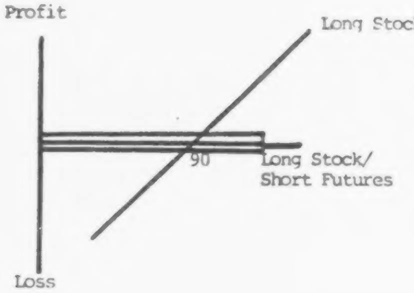
Profit/Loss on Stocks and Hedged Stock Portfolios

		70	80	85	90	95	100	110
a)	Long Stock	-20	-10	-5	0	+5	+10	+20
b)	Long Stock/	-20	-10	-5	0	+5	+10	+20
	Short Futures	+20	+10	+5	0	-5	-10	-20
	Net	0	0	0	0	0	0	0
c)	Long Stock/	-20	-10	-5	0	+5	+10	+20
	Long Put	+15	+5	0	-5	-5	-5	-5
	Net	- 5	-5	-5	-5	0	+5	+15
d)	Long Stock/	-20	-10	-5	0	+5	+10	+20
	Short Call	+5	+5	+5	+5	0	-5	-15
	Net	-15	+5	0	+5	+5	+5	+5

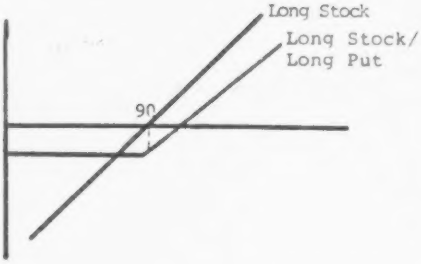
Exhibit 6

Profit/Loss Profiles of Hedged Stock Portfolios

1) Long Stock/Short Futures



2) Long Stock/Long Put



3) Long Stock/Short Call

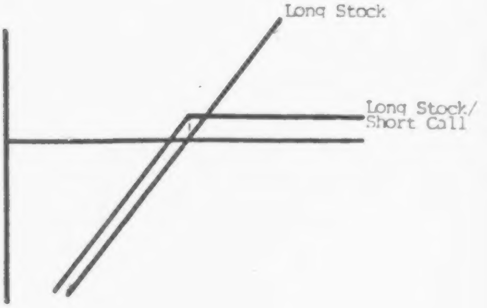


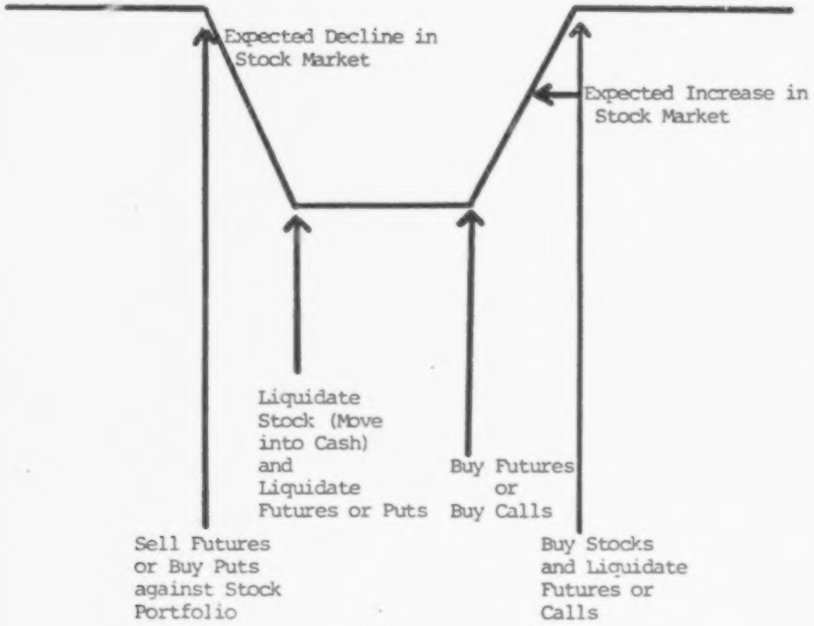
Exhibit 7

Futures and Options: Risk/Profit Potential

	Loss Potential	Profit Potential
Future	Unlimited	Unlimited
Put		
Long	Limited (to Premium)	Unlimited
Short	Unlimited	Limited (to Premium)
Call		
Long	Limited (to Premium)	Unlimited
Short	Unlimited	Limited (to Premium)

Exhibit 8

Marketing Timing Strategy


Expected Decline in Stock Market
Expected Increase in Stock Market
Liquidate Stock (Move into Cash) and Liquidate Futures or Puts
Buy Futures or Buy Calls
Sell Futures or Buy Puts against Stock Portfolio
Buy Stocks and Liquidate Futures or Calls

Effects of Using Futures/Options

- More rapid shift due to liquidity of futures/options markets
- Low transactions costs

FEDERAL RESERVE SYSTEM

Regulations G, T and U

[12 CFR 207, 220 and 221]

[Docket No. R-0385]

SECURITIES CREDIT TRANSACTIONS

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: The Board of Governors, pursuant to its authority under the Securities Exchange Act of 1934, is considering establishing margin requirements for futures contracts based on stock indexes. The Board is now requesting comments on a proposed regulatory framework which could be used to implement a decision to establish margin requirements for futures contracts based on stock indexes.

DATE: Comments should be received on or before April 30, 1982.

ADDRESS: Comments, which should refer to Docket No. R-0385, may be mailed to the Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551 or delivered to Room B-2223 between 8:45 a.m. and 5:15 p.m. Comments received may also be inspected at Room B-1122 between 8:45 a.m. and 5:15 p.m. except as provided in section 261.6(a) of the Board's Rule Regarding Availability of Information (12 CFR § 261.6(a)).

FOR FURTHER INFORMATION CONTACT: Laura Homer, Securities Credit Officer or Robert Lord, Attorney, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (202) 452-2781.

SUPPLEMENTARY INFORMATION: The Board has reviewed the question of applying margin requirements to any futures contracts involving a broadly-based stock index in light of approval by the Commodity Futures Trading Commission (CFTC) of an application by the Kansas City Board of Trade ("the Applicant") to trade such a contract. In considering the matter, the Board took into account that stock index futures contracts can, to an important degree, compete

EXHIBIT B

with, and be an economic substitute for, stock options, on which margin requirments are currently imposed. In addition to limiting the use of speculative credit, margin requirements, therefore, may be appropriate to assure competitive equality among functionally similar instruments.

The Board understands that the Applicant has raised the initial margin on its stock index futures contract for a non-hedging position to a dollar level approximately equal to ten percent of the current value of the contract, and has raised margin requirements for hedging transactions to one half of that amount. In addition, the Board understands that the Applicant has taken steps to narrow the definition of hedging for margin purposes to better assure that situations permitting the lower margin requirement represent a true hedging transaction, a direction the Board believes appropriate.

The actions by the Applicant would appear to alleviate the need for immediate action by the Board and, consequently, the Board has decided not to specify at this time particular margin requirements on stock index futures contracts such as the one approved by the CFTC. The Board plans to monitor closely the development and operation of the market in stock index futures contracts so that an informed judgment on the matter can be reached based on experience.

Although the Board has decided not to specify margin requirements on stock index futures contracts at this time, there is a clear possibility that Board action may be necessary in the future. Therefore, the Board is asking for comment on specific issues, including a regulatory framework suggested by its staff, so that the Board may be fully prepared in the event a formal margin regulation become necessary. The public is asked to comment on the following specific issues in connection with stock index futures contracts and related instruments:

1. The appropriate level of margin;

2. the appropriate definition of a hedged transaction;

3. the use of Regulation G or T to cover futures commission merchants that may not otherwise be subject to the Board's margin regulations;

4. the proper customer account to use in Regulation T for these instruments; and

5. the treatment of bank loans and loans from other lenders for the purpose of meeting margin calls and related costs.

The objective of several of the foregoing questions is to design a regulatory framework that would create the least operational problems for broker-dealers presently subject to Regulation T and those firms not presently covered, while providing comparable treatment of the two groups. Specific comment is invited with respect to the following framework which has been suggested by Board staff.

First, a futures commission merchant would be considered a "creditor" subject to Regulation T, but only with respect to transactions in stock index futures contracts. Second, any Regulation T "creditor" who executes a stock index futures contract for a public customer would be required to obtain a specified initial margin. Third, transactions in stock index futures contracts would be required to be maintained in the "special commodity account" which presently exists in Regulation T. Fourth, credit extended to customers by banks and other lenders for the purpose of meeting a commitment under a stock index futures contract would be considered "purpose" credit. Thus, credit extended for such a purpose would be subject to the current margin level applicable to other "purpose" loans collateralized by margin securities. Finally, the level of margin would be placed in the Supplement to Regulation T with other margin levels.

By order of the Board of Governors of the Federal Reserve System, February 24, 1982.

(signed) William W. Wiles

William W. Wiles
Secretary of the Board

[SEAL]

The S&P 100™ Stock Index Futures Contract: Flexibility for Today's Investor

Markets For Today's Investor

CHICAGO
MERCANTILE
EXCHANGE
International Monetary Market • Index and Option Market

The S&P 100 Stock Index Futures Contract: Flexibility for Today's Investor

Now investors can participate in—or hedge against—movements in the overall stock market with a new, smaller S&P futures contract. The new S&P 100 futures contract combines the leverage and ease of the futures market with an index that tracks the stock market as a whole—all using a contract consistent with a smaller portfolio size.

Just as professional money managers are using the larger S&P 500 futures contract to increase their return on investment, investors now can use the smaller, S&P 100 contract in a number of market strategies:

- to participate in market moves, with one trading decision, when specific stock selections are not obvious (and not requiring an up-tick when selling short),
- to protect a portfolio during bearish market periods without the expense of portfolio liquidation,
- to speculate on short-term market moves and still receive attractive tax treatment, and
- to gain immediate exposure to a bull market move even while awaiting funds to purchase stocks.

What is the S&P 100 Index? The Standard & Poor's 100 Index is a market-weighted average of prices of 100 actively traded, largely blue-chip stocks. The stocks comprising the Index and their weights are listed on the back panel of this brochure. The Index values are updated continually throughout the trading day, and they are available through brokers and market-information dissemination services. The closing value of the S&P 100 Index appears daily in **The Wall Street Journal** and other major newspapers. Index figures for the preceeding week are carried in **Barron's**.

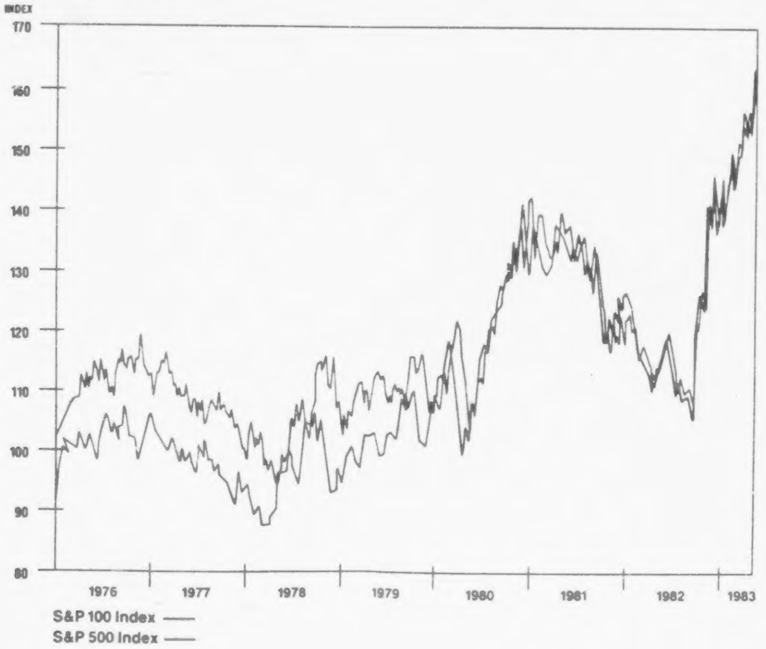
What is the S&P 100 Futures Contract? Futures contracts based on the S&P 100 Index are traded on the Index and Option Market division of the Chicago Mercantile Exchange. The price of the future will tend to move with the price of the underlying Index. While the actual Index price is a calculated value, the futures price is determined by open outcry auction on the floor of the Exchange. Although the futures and the underlying Index may be at different levels throughout the life of the contract, the

EXHIBIT C

futures contract is designed so that, on the settlement day, the Index value and the closing futures contract price are identical.

Advantages of a Smaller Contract. Futures contracts based on the S&P 100 Index are of a much smaller dollar amount than those of the broader S&P 500 Index. As a result, the holder of an S&P 100 future is exposed to a reduced dollar risk relative to the holder of a larger S&P 500 future. The dollar value of a single S&P 100 futures contract is computed by multiplying the future value by $200. In comparison, the value of the S&P 500 futures contract is $500 times its price. Historically, the level of the two indexes has been extremely close (see accompanying chart), meaning that the value of the futures contract on the S&P 100 is roughly 40 percent of one on the S&P 500. Thus, on a day when the S&P 500 changed in value by, say, $500, the S&P 100 contract typically would change by about $200. Put another way, the value of each tick for the S&P 500 future is $25, while the value of each tick on the S&P 100 futures is only $10. Margin required for the S&P 100 contract is also smaller—approximately 10 percent of the contract value on a speculative position, less on a hedge position. ■

Comparison of Weekly Values January 1976-April 1983



Cumulative Market Value of Stocks Comprising the S&P 100 Index and Percentage of Total S&P 100

Companies on the S&P 100 Stock Index	Market Value* (in millions)	% of 100	Cumulative %
1. American Tel. & Tel.	61919.199	12.15	12.15
2. International Bus. Mach.	59025.409	11.58	23.73
3. Exxon Corp.	26189.139	5.14	28.87
4. General Electric	23459.432	4.60	33.47
5. General Motors	19447.035	3.82	37.29
6. Eastman Kodak	13851.846	2.72	40.01
7. Schlumberger	13231.192	2.60	42.61
8. Standard Oil (Indiana)	11813.119	2.32	44.93
9. Mobil Corp.	11013.215	2.16	47.09
10. Atlantic Richfield	10784.124	2.12	49.21
11. Sears, Roebuck	10039.704	1.97	51.18
12. Hewlett-Packard	9898.063	1.94	53.12
13. DuPont (E.I.)	9453.040	1.86	54.98
14. Johnson & Johnson	9047.259	1.78	56.76
15. Minn. Min. & Mfg.	8834.802	1.73	58.49
16. Coca-Cola	6784.200	1.33	59.82
17. Digital Equipment	6730.791	1.32	61.14
18. Merck & Co.	6343.442	1.24	62.38
19. American Express	6264.522	1.23	63.61
20. Tandy Corp.	5764.008	1.13	64.74
21. Dow Chemical	5573.303	1.09	65.83
22. R.J. Reynolds	5506.746	1.08	66.91
23. Ford Motors	4777.428	.94	67.85
24. Weyerhaeuser	4657.035	.91	68.76
25. Bristol-Myers	4635.213	.91	69.67
26. Citicorp	4451.828	.87	70.54
27. International Tel. & Tel.	4164.300	.82	71.36
28. Texas Instruments	4158.704	.82	72.18
29. Raytheon Co.	4053.232	.80	72.98
30. Halliburton	4044.035	.79	73.77
31. Superior Oil	3916.412	.77	74.54
32. Rockwell-International	3637.883	.71	75.25
33. Commonwealth Edison	3624.411	.71	75.96
34. McDonald's	3539.823	.69	76.65
35. Boeing	3511.533	.69	77.34
36. Monsanto	3394.590	.67	78.01
37. Baxter Travenol Labs	3373.612	.66	78.67
38. United Technologies	3315.723	.65	79.32
39. K mart	3283.451	.64	79.96
40. Norfolk Southern	3281.189	.64	80.60
41. Amer. Electric Power	3258.546	.64	81.24
42. PepsiCo	3285.558	.63	81.87
43. Xerox	3081.435	.60	82.47
44. Teledyne	3062.549	.60	83.07
45. CIGNA Corp	2962.811	.58	83.65
46. BankAmerica	2915.376	.57	84.22
47. Amer. Hospital Supply	2913.028	.57	84.79
48. AMP	2639.312	.52	85.31
49. Aluminum Co. of Amer.	2593.739	.51	85.82
50. Northern Telecom Ltd.	2585.368	.51	86.33
51. NCR Corp.	2505.838	.49	86.82
52. International Paper	2444.528	.48	87.30
53. Avon Products	2405.333	.47	87.77
54. Merrill Lynch	2393.638	.47	88.24
55. Humana, Inc.	2378.703	.47	88.71
56. Burlington Northern	2355.525	.46	89.17
57. Litton Industries	2280.398	.45	89.62
58. Disney Productions	2242.653	.44	90.06
59. Squibb Corp.	2224.244	.44	90.50
60. General Dynamics	2056.446	.40	90.90
61. Honeywell, Inc.	2004.517	.39	91.29
62. General Foods	1981.044	.39	91.68
63. Ralston Purina	1928.120	.38	92.06
64. Warner Communications	1900.892	.37	92.43
65. Burroughs Corp.	1867.300	.37	92.80
66. Delta Airlines	1829.052	.36	93.16
67. Fluor Corp.	1811.034	.36	93.52
68. Control Data	1667.061	.33	93.85
69. Sperry Corp.	1654.554	.32	94.17
70. Colgate-Palmolive	1618.572	.32	94.49
71. RCA Corp.	1603.589	.31	94.80
72. Upjohn Co.	1531.229	.30	95.10
73. Holiday Inns	1384.887	.27	95.37
74. Gulf & Western Ind.	1313.624	.26	95.63
75. Champion International	1298.241	.25	95.88
76. Tektronix, Inc.	1280.801	.25	96.13
77. Harris Corp.	1270.763	.25	96.38
78. Safeway Stores	1181.839	.23	96.61
79. Hughes Tool	1165.973	.23	96.84
80. Revlon, Inc.	1183.037	.22	97.06
81. Homestake Mining	1051.849	.21	97.27
82. Northwest Airlines	1023.482	.20	97.47
83. International Minerals	1011.151	.20	97.67
84. UAL, Inc.	1005.958	.20	97.87
85. Boise Cascade	993.979	.20	98.07
86. International Flavors	896.087	.18	98.25
87. Polaroid Corp.	893.826	.18	98.43
88. Black & Decker	879.005	.17	98.60
89. Bethlehem Steel	862.720	.17	98.77
90. Esmark, Inc.	829.742	.16	98.93
91. Storage Technology	765.811	.15	99.08
92. Northwest Industries	746.744	.15	99.23
93. Owens-Illinois	734.800	.14	99.37
94. National Semiconductor	675.271	.13	99.50
95. Great Western Financial	628.025	.12	99.62
96. Williams Co.	602.883	.12	99.74
97. Datapoint	446.806	.09	99.83
98. Brunswick Corp.	301.626	.06	99.89
99. Computer Sciences	286.724	.06	99.95
100. Skyline	252.383	.05	100.00
	509744.021		

*As of 1/31/83

*As of 1/31/83

Contract Terms

Underlying Index	S&P 100 Stock Price Index
Ticker Symbol	SX
Contract Size and Value	Each futures contract represents $200 times the current value of the S&P 100 Index. (For example, if 162.35 represents a current Index level, the value of the S&P 100 contract is $200 × 162.35, or $32,470.)
Contract Months	March, June, September, December
Trading Hours	9:00 a.m. to 3:15 p.m. CST (3:00 p.m. on last day of trading in expiring contract)
Minimum Price Fluctuation (Tick Size)	.05 ($10)
Daily Price Limit	None
Last Trading Day	Third Friday of the contract month
Settlement Procedure on Last Trading Day	Cash settlement. All open positions at the close of the final trading day are marked to the actual closing value of the S&P 100 Index. Cash settlement is based on the **difference** between the future's settlement price on the business day preceding the last trading day and the value of the S&P 100 Index at the close of the final trading day. There is **no delivery of securities,** and the **full value of the contract is not transferred.**

Minimum Margin*	*Initial*	*Maintenance*
Speculative	Approx. $3,000**	$1,200
Hedge	$1,500	$1,200

**Subject to change by CME Board of Governors. Please consult your broker to verify current margin requirements. The amounts shown represent Exchange minimum requirements.*

***Exact margin undetermined as of publication date 6/83.*

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Mr. GUARINI. Thank you very much. Mr. Scribner, who is executive vice president of the American Stock Exchange, we welcome you, sir, and appreciate your comments.

STATEMENT OF RICHARD O. SCRIBNER, EXECUTIVE VICE PRESIDENT FOR LEGAL AND REGULATORY AFFAIRS, AMERICAN STOCK EXCHANGE

Mr. SCRIBNER. Thank you, Mr. Chairman. My name is Richard O. Scribner. I am executive vice president for legal and regulatory affairs at the American Stock Exchange.

I am here today to testify in behalf of the Amex with respect to the tax treatment of options on securities and commodities futures contracts. Because of our dual role as a major exchange for the trading of both stocks and options, we approach these issues with a uniquely broad perspective.

We firmly believe that parity of tax treatment between competing products which have essentially similar characteristics is sound tax policy and a highly desirable goal. Investment products should thrive or fail on the basis of their merits as determined in the marketplace and not as a result of differences in tax treatment.

We have been concerned, for example, with the prospect that options on futures might receive an unfair competitive advantage over options on the same underlying instrument by virtue of being accorded the maximum 32-percent tax rate currently applicable to regulated futures contracts versus the 50-percent maximum tax rate applicable to options.

Options on futures serve a virtually identical economic function to options directly on the underlying property. We are dismayed, therefore, that the Senate Finance Committee on Monday proposed to codify this competitive disadvantage that we have feared, and we strongly urge this committee to reject that Senate action.

On a broader scale, we believe that sound tax policy requires a thorough and detailed analysis of the nature and extent of the competition between existing and anticipated futures and options products. Sound tax policy also requires careful analysis of the impact of changes in the tax treatment of exchange-listed options on the markets for underlying properties, particularly the markets for stock and fixed income securities.

Obviously the crucial role of these markets in the capital formation process makes it imperative that they not be adversely affected through a tax regime applicable to their derivative products. Sound tax policy requires a careful study of all alternatives to achieving tax parity between competing products, including not only the extension of the 60-40 regime to options but also the possible removal from that regime of equity and debt-related futures contracts, as well as other possible solutions.

The Amex appreciates that modifications to the tax treatment of listed options are necessary to eliminate tax-motivated transactions that appear to have developed in recent years. The chief focus seems to be on the use of limited partnerships, or syndicates, to pass through paper losses from tax-motivated straddle positions in stock options to their limited partners as ordinary losses, and to general concerns about the use of straddle positions in stock options to defer gains from 1 year to another.

It is our understanding that these schemes are susceptible to attack on audit where any particular transaction is principally tax motivated or lacks economic substance. We note also that the syndicate problem would be effectively eliminated by a provision similar to that in S. 13, introduced by Senator Dole, which would also reduce the long-term holding period to 6 months—a proposal which, echoing what Mr. Ball and Dr. Albertine said earlier, the Amex enthusiastically supports.

The Amex is particularly concerned that measures to correct abuses not adversely affect legitimate nonabusive option investment strategies. The covered call is a case in point. The writer of a call option who owns the underlying property, stock for example, is able through receipt of the option premium to increase his investment return. This strategy is employed by large numbers of investors for this perfectly legitimate purpose.

On the other hand, the same basic strategy, slightly modified to use deep in the money calls could be used to defer taxes on unrelated gains. It is essential that any legislation to correct abuses involving deep-in-the-money covered calls distinguish and exempt covered calls which are not deep in the money.

The distinction must be made at a level which exempts legitimate covered call strategies and which can be readily understood and applied in the markets. This is a delicate task.

We believe that the statutory correction of any tax abuse involving options can and should be accomplished in the context of the full analysis of the tax treatment of options and other derivative products which we are urging. We believe that it would be a serious mistake to revise the tax treatment of exchange-listed options in order to correct identified abuses until the overall effect of such revisions on the markets for these derivative products and their underlying products has been carefully studied.

In conclusion, we urge Congress to formally undertake this analysis, which in a sense is beginning today with this hearing. We believe the goal should be the enactment early in the next session of any remedial legislation which may be deemed necessary. We pledge the full cooperation of the American Stock Exchange and believe that all segments of the securities industry will lend their support to this effort.

Thank you.

[The prepared statement follows:]

Statement of Richard O. Scribner, Executive Vice President, Legal and Regulatory Affairs, American Stock Exchange

SUMMARY OF COMMENTS

1. Competing products which have essentially similar characteristics should be subject to the same tax treatment.

2. Options on futures serve a virtually identical economic function to, and compete directly with, options on the same underlying property, and should, therefore, be subject to the same tax treatment.

3. The nature and extent of the competition between options, futures and the underlying property is complex and has not been the subject of critical analysis. Sound tax policy requires a thorough analysis of (i) the nature and extent of that competition, (ii) the importance of differences in tax treatment on this competition, and (iii)

the advantages and disadvantages of all available alternatives to achieving tax parity.

4. Measures to correct abuses should not adversely affect legitimate non-abusive option investment strategies. In particular, the "covered call" transaction, which enables an owner of property to increase his investment return through the writing of a call option, should not be subject to the anti-straddle rules.

5. The Amex urges Congress to formally undertake a comprehensive analysis of the tax treatment of options and other investment vehicles with the goal of enactment early in the next session of any remedial legislation which might be deemed necessary, and pledge its full cooperation in this effort.

STATEMENT

My name is Richard O. Scribner. I am Executive Vice President for Legal and Regulatory Affairs of the American Stock Exchange. With me today is Joseph F. McDonald of Lord, Day & Lord, counsel to the Exchange.

I am here today to testify on behalf of the Amex with respect to the tax treatment of options on securities and commodities futures contracts. We appreciate the Committee's interest in this subject, which has considerable significance for the securities industry and, in fact, virtually all financial markets.

We at the Amex have been deeply interested in the tax treatment of options on securities and competing investment products. As a result of our dual role as a major exchange for the trading of both stock and options, we approach these issues with a uniquely broad perspective.

We are committed in our traditional role to providing a highly efficient, closely regulated market for trading the stocks of some 850 mid-range American companies. This market is an essential complement to the ability of these companies to raise equity capital from investors.

As an options exchange, the Amex began trading in stock options, following SEC approval, in January of 1975. We presently list contracts covering 106 issues of underlying stock and trading volume is currently running at an average of approximately 142,000 contracts a day, which represent 14,200,000 shares of underlying stock.

The Amex has also been a major innovator of new "non-stock" options products. In October of 1982 the Amex inaugurated trading in options on United States Treasury Bills and Treasury Notes. This year we began trading options on two broad based stock indices, the Major Market Index and the Market Value Index, and on two narrow-based industry stock indices: a computer technology index and an oil and gas index. The Amex has applications pending with the SEC and the CFTC for permission to trade option contracts on 10 additional underlying properties, including gold bullion and other narrow-based stock indices.

The immense popularity of exchange-listed options reflects the use of these investment vehicles by a broad spectrum of individual and institutional investors to shift the risks inherent in buying, holding or selling the underlying properties.

Investors generally will not make direct capital investments in enterprises unless a market exists where they will be readily able to dispose of those investments, whether at a profit or loss, when they see fit. In addition, investors are far more willing to make direct capital investments, and to participate in the secondary markets, when they have opportunities to reduce the risks of their capital investment short of an outright sale of that investment.

Listed options markets, such as those provided by the American Stock Exchange, exist primarily to provide just such opportunities. A report of the Special Study of the Options Market to the SEC in 1979 concluded that exchange-listed stock options provide "useful alternative investment strategies," including "a means for shifting the risk of unfavorable short-term stock price movements from owners of stock who have, but do not wish to bear, such risks, to others who are willing to assume such risks in anticipation of possible rewards from favorable price movements." [1] Non-stock options provide similar benefits for markets in their underlying properties.

Risk-shifting is accomplished through the use of options in a variety of ways. The most basic transaction, the purchase of a call option, enables the holder of the option to benefit from a price increase in underlying property while the risk of loss from a price decrease is shifted, for a fee (or premium) to the writer of the option. Another very basic options transaction is to write a call option while owning the underlying property, typically stock or other securities (a so-called "covered call"). The writer receives an increased return on the underlying property through the premium, while reducing or eliminating his participation in any price increase in the underlying property. Numerous other risk-shifting profit-motivated strategies are employed by investors using listed options.

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[1] Report of the Special Study of the Options Markets to the Securities and Exchange Commission, Committee Print 96-IFC3, December 22, 1978. Quotations are from the covering letter to the Report by Richard L. Teberg, Director, and from page 1 of the Report.

It is important to appreciate the vital role played by market makers in the effective operation of the stock and options markets. Market makers on registered national securities exchanges are required by regulations of the SEC and exchange rules to provide orderly and continuous markets for investors. They fulfill their functions and responsibilities by risking their capital in short-term positions in those securities for which they are responsible. They must continually shift between long and short positions in their securities and, as an economic necessity, hedge their risks in every available way. The capital markets cannot exist without market makers, who, by risking their capital, provide the basic ingredients of liquidity and continuity which enable the markets to function.

We firmly believe that parity of tax treatment between competing products which have essentially similar characteristics is sound tax policy and a highly desirable goal. Investment products should thrive or fail on the basis of their respective merits as determined in the marketplace and not as a result of differences in tax treatment.

A clear example is presented by the case of options on futures. We have been concerned with the prospect that options on futures might receive an unfair competitive advantage over options on the same underlying instrument by virtue of being accorded a maximum 32 percent tax rate without regard to holding period (the so-called 60/40 tax treatment currently applicable to regulated futures contracts) versus the 50 percent maximum rate applicable to options on the same property. [The options cannot be held for the 12 months currently required to achieve the reduced rate for long-term capital gain.] Options on futures are options contracts which serve a virtually identical economic function to options directly on the underlying property. We were recently gratified to learn that the Treasury Department has "initially" concluded that options on futures are not entitled to the preferential tax rate. We urge the Treasury to finalize this conclusion, and hope that Congress will promptly enact any technical legislation the Treasury deems necessary to effectuate this result.

On a broader scale, the Amex has been carefully considering the nature and extent of the competition which currently exists, and can be expected to exist in the future, between exchange-listed options and regulated futures contracts; the impact on that competition of the disparity in tax treatment applicable to options and futures; and various alternatives for alleviating that disparity. There is a substantial question at this point in the mind of the securities industry whether inclusion of exchange-listed options in the tax regime currently applicable to regulated commodity futures is necessary to protect competition between the two types of investment vehicles, and whether that would represent sound tax policy in any case.

Currently, markets for securities or physical commodities and futures and options markets for the same underlying properties co-exist in only a few instances. Listed options on foreign currencies and fixed income securities have not traded heavily compared to established futures markets for these properties. Markets currently exist for both futures and exchange-listed options on broad-based stock indices, and both types of products are in many cases trading significant numbers of contracts.

On the other hand, it seems logical that competition, of varying degrees, must exist between virtually all investment vehicles. To some measure investments in stock, for example, must compete with investments in stock options, both of which compete, probably to varying extents, with options and futures on broad and narrow based stock indices, which in turn compete, more or less, with each other. These interrelationships are complex and have not been the subject of critical analysis. It is possible that non-tax considerations, such as differences in the basic economic relationships, or the mark-to-the-market margining system utilized in the futures markets but not in the "spot" or options markets, may be stronger factors in whatever competition exists between these various investment vehicles than the different tax treatment applicable to each.

We believe that sound tax policy requires a thorough and detailed analysis of the nature and extent of the competition between existing and anticipated futures and options products and the impact of the different tax treatment applicable to these products on this competition. We believe that sound tax policy would also require careful analysis of the impact of any change to the tax treatment of exchange-listed options on the markets for underlying properties, particularly the markets for stock and fixed income securities. Obviously, the crucial role of these markets in the capital formation process makes it imperative that they not be adversely affected through a tax regime applicable to their derivative products. Sound tax policy requires a careful study of all alternatives to achieving tax parity between competing products, including not only the extension of 60/40 regime to options, but the possible removal from that regime of equity and debt-related futures contracts, as well as other possible solutions.

The Amex appreciates that modifications to the tax treatment of listed options are necessary to eliminate certain tax-motivated transactions that appear to have developed in recent years. The chief focus seems to be on the use of limited partnerships, or "syndicates", ostensibly engaged in acting as market makers in options, which purport to be able to pass through paper losses from tax-motivated straddled positions in stock options to their limited partners as ordinary losses. Concern also exists over the general use of straddle positions in stock options to defer gains from one year to another.

It is our understanding that these schemes are susceptible to attack on audit where any particular transaction is principally tax-motivated or lacks economic substance. We note that the "syndicate" problem would be effectively elminated by a provision similar to that in S. 13 introduced in the Senate by Senator Dole which would also reduce the long-term holding period to 6 months (a proposal which, incidentally, the Amex enthusiastically supports).

The Amex is particularly concerned that measures to correct abuses not adversely affect legitimate non-abusive option investment strategies. The "covered call" which I described earlier is a case in point. The writer of a call option who owns the underlying property is able, through receipt of the option premium, to increase his investment return at the expense of not enjoying the benefit of any price increase in the property. This strategy is employed by large numbers of investors for this perfectly legitimate purpose. On the other hand, the same basic strategy, slightly modified, could be used to defer taxes on unrelated gains. If the option is written at an exercise price which is substantially below the current market price for the underlying property, price changes either way in the property will be offset by price changes in the option. Consequently these "deep-in-the-money" covered calls might be used as an abusive tax straddle.

It is essential that any legislation to correct an abuse involving "deep-in-the-money" covered calls distinguish and exempt covered calls which are not "deep-in-the-money." The distinction must be made at a level which exempts all legitimate covered call strategies and which can be readily understood and applied in the markets. This is a delicate task.

We believe that the statutory correction of any tax abuses involving options can and should be accomplished in the context of the full analysis of the tax treatment of options and other derivative products which we are urging. In fact, we believe that the necessity for, and scope of, legislation to eliminate tax abuses connected with derivative products should be high on the agenda of items in the Congress' analysis of this area. We believe that it would be a serious mistake to undertake a major revision of the tax treatment of exchange-listed options in order to correct identified abuses unless and until the overall effect of such revisions on the markets for these derivative instruments and their underlying products has been carefully studied. Even a more limited statutory effort to correct these abuses without a careful study of the full impact of such changes could seriously damage these sensitive markets. Such limited effort could also present a significant impediment to the thorough analysis which the Amex suggests and the implementation of any broader statutory revisions which the analysis might recommend.

We urge Congress to formally undertake this analysis, which, in a sense, is beginning today with this Hearing. We believe the goal should be the enactment early in the next session of any remedial legislation which might be deemed necessary. We pledge the full cooperation of the American Stock Exchange, and believe that all segments of the securities industry will lend their support to this effort.

We greatly appreciate the Committee's interest in these important issues and thank you for this opportunity to present the views of the American Stock Exchange.

Mr. GUARINI. Thank you very much, Mr. Scribner.

Mr. John S. Nolan, counsel to the Options Policy Association.

STATEMENT OF JOHN S. NOLAN, COUNSEL, OPTIONS POLICY ASSOCIATION

Mr. NOLAN. Thank you, Mr. Guarini.

I appear today for the Options Policy Association, an association of market makers primarily on the Chicago Board Options Exchange. These market makers are professional traders who make it possible for the markets in options on stock to work efficiently. They stand ready to buy or sell options at all times so that the options market has its essential liquidity.

We strongly urge this committee to adopt the essential elements of the CBOE proposal for the tax treatment of options on stock. This proposal would treat all options the same as regulated futures contracts were treated in the 1981 act. It would thereby provide the same tax treatment for these comparable financial products, and it would prevent tax avoidance.

We in the Options Policy Association propose additional provisions to make the CBOE proposal work more simply and effectively for market makers and to insure that there will be no tax avoidance. Our proposal would eliminate the complexity with respect to mixed straddles, which is a matter of concern in the staff's discussions of the CBOE proposal at page 32 of the pamphlet for this hearing.

It also would resolve a principal basis of the Treasury's concern, as stated today, as to the application of mark-to-market rules to options on stock.

The options markets are extremely important to the economy. They are a vital element in efficient capital formation. They induce savings by making it possible for savers directly or through financial intermediaries, such as pension funds or insurance companies, to own corporate stock or debt instruments and earn dividends or interest without taking the risk of market fluctuations in value of those investments. This in turn makes it possible for businesses to raise capital by selling stock or debt more easily and less expensively. Pension funds, insurance companies, banks, savings institutions, and individual investors all benefit directly from the options markets. Portfolio managers can more efficiently and carefully adjust the degree of risk that they want to assume; investors who desire leveraged risk investment can efficiently take those risks from investors who wish to invest without those risks.

The market makers we represent are essential to this process. They provide liquidity to the options market so that, whether prices are rising or falling there is always a ready market for the options. They are professional traders, performing essentially the same function as the commodities futures traders or stock specialists on the stock exchanges.

Options on stock and commodity futures have the same purpose and effect; the risk of market fluctuations is shifted from those seeking to avoid such risks while holding the underlying stock or commodity to risk takers willing to assume such risks for compensation.

The options and futures markets directly compete with one another in some areas. Both options and commodity futures are presently sold on Treasury bills, Treasury bonds, foreign currencies, the S&P 100 Index, and the S&P 500 Index. The extent of this overlap is growing and this growth may accelerate.

Each of these sets of markets is vital to our economy. Public trading in commodities supports business activity in an infinite variety of ways. Public trading in stock and securities is at the heart of business investment and is vital to capital formation.

Market forces alone should determine the choice of market or product to achieve the result. Any substantial disparity in tax treatment favoring one or the other type of contract will greatly distort those forces and result in a shift toward the tax-favored type of contract. The CBOE proposals which we strongly support today, provide equality of tax treatment for the commodity futures markets and the options markets. At the same time, these proposals will completely stop the tax avoidance at which the 1981 act changes were directed.

Action at this time is necessary because tax deferral from options trading has become a serious problem. By far the most effective way of dealing with this tax problem is the mark-to-market system adopted for commodity futures transactions in 1981. This system accelerates gains on these transactions as of each yearend so that losses cannot selectively be realized without also realizing gains. Because gains are accelerated, whether or not to offset losses, Congress deemed it fair in 1981 to make both gains and losses 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss, an effective tax rate of 32-percent. This system is equally appropriate for options on stock.

The 32-percent rate applicable to mark-to-market gains represents a fair compromise for the significant tax disadvantages suffered by a taxpayer under the mark-to-market rules. Under these rules, options gains will be accelerated before they are realized into an earlier year. The exercise of an option will now become a taxable event. The long-term portion of option losses will eliminate other long-term gains. This 32-percent rate was considered a reasonable compromise for futures contracts in 1981 because of these effects, and it is just as reasonable for options today. It would be grossly unfair to option market makers to accelerate their gains by a mark-to-market system, as the Treasury has suggested today, without providing them the same 32-percent rate that is given to professional commodity traders under the 1981 legislation.

It also would threaten the essential liquidity of the option markets. If market makers must pay a 50-percent rate of tax on gains they have not realized, they will be under much greater pressure to sell some of their open positions at each yearend to raise cash to pay this tax.

This could distort market prices. It could threaten market makers with economic loss from forced sales. It could seriously harm orderly and efficient option markets and thereby adversely affect the stock markets. Much of the capital formation benefits of efficient option markets would be lost.

The application of a 32-percent rate to options gains and losses does not create a revenue loss. The option market, like the commodtities market, is essentially a zero sum system because for every winner there is a loser. Although the system is not perfectly symmetrical the relatively minor lack of symmetry is not sufficient enough to cause either revenue gains or losses that change significantly the zero sum result.

In conclusion, I reiterate that the CBOE proposal recognizes that options and futures are competitive products that perform essentially the same economic functions through shifting of risk or benefit of market fluctuation that they attract essentially the same type of investors, and they are traded by professional market makers performing essentially the same functions, providing liquidity to their respective markets.

It makes no sense whatsoever to tax these competitive products and the taxpayers involved differently. The CBOE proposal with the additions we recommend will stop tax avoidance in these markets without harming the essential capital formation advantages of both sets of markets.

Thank you.

[The prepared statement follows:]

Statement of John S. Nolan, Counsel, Options Policy Association

INTRODUCTION

I am John S. Nolan of Miller & Chevalier, Chartered, Washington, D.C. I appear for The Options Policy Association, Chicago, Illinois ("TOPA"). TOPA's 250 members are market makers, primarily on the Chicago Board Options Exchange ("CBOE"). The average daily trading volume on the CBOE is equivalent to over 25 million shares, a sizeable percentage of which is accounted for by TOPA members.

I strongly urge this Committee to adopt the essential elements of the CBOE proposal for the tax treatment of options on stock. The proposal has four principal purposes. First, it would eliminate any income deferral possibilities that may exist under current law due to the exclusion of stock options from the loss deferral rules of section 1092. Second, it would provide comparable tax treatment for comparable financial products by treating options as regulated futures contracts under section 1256. Third, it would resolve the current uncertainty as to the proper treatment of cash settlement options and commodity options. Fourth, it would simplify the application of sections 1092 and 1256 in the context of the option markets. We propose additional provisions to make the proposal work more effectively for market makers and to insure that there will be no tax avoidance.

OVERVIEW

1. The capital formation effect of trading in options on stock. The trading of options on stock, just like the trading of commodity futures, provides extremely valuable flexibility and strength to our economy. Both are critical risk-shifting processes that facilitate business activity. Commodity futures trading enables owners of underlying commodities, like farmers, to shift the risk of price changes in those commodities to investors willing to accept market risks to earn profits, at the risk of incurring losses, on such investment activity. In very much the same way, trading of options on stock (hereinafter used generically to include all securities) enables investors in stock who seek to minimize the risk of stock market fluctuations in their holdings to shift such risks to other investors willing to accept such risks. Thus, pension funds, insurance companies, banks, savings institutions, and other large institutional and individual portfolio holders, regularly seek to shift the risk of stock market fluctuations in value to other investors willing to accept such risks to earn profits, at the risk of incurring losses, in such transactions.

Trading in options on stock thereby greatly improves the capital formation process by providing stronger and more flexible capital markets. This induces saving directly or through financial intermediaries, such as those named above, encouraging investment in stocks and corporate bonds by providing the means to achieve greater safety. Bias in favor of the safest forms of investment with lower yields, such as Treasury bills, is reduced, thereby improving capital markets. The growth of trading in options on stock in recent years is the strongest evidence of the vital economic functions served by such trading.

2. The role of option market makers. Market makers trading options on stock, just like commodity futures traders, are the professionals who make these specialized markets work. They are like stock specialists on a stock exchange. They have a duty imposed by SEC regulation and exchange rules to buy and sell options as required to maintain an orderly market in their specialty (for example, IBM options). This duty imposed on market makers assures investors that there will always be a ready market for their options, whether prices are rising or falling. Without market

makers, liquidity in options would be reduced because a public buyer would have to be found for every seller before a trade could occur. An illiquid options market would be a very little value to anyone, and would not be capable of handling the large volumes of transactions currently handled. This, in turn, would mean that the extraordinary capital formation efficiencies gained in our economy from options markets, as previously described, would be lost.

3. The importance of options on stock. The importance of trading in options on stock to our economy is very substantial. The volume of options trading last year was equal to approximately 83 percent of the volume (on a share equivalent basis) of the volume on the New York Stock Exchange. Over 137 million contracts representing a share equivalent basis of 13.7 billion shares were traded on four exchanges.

4. Commodity futures and options on stock are directly competitive, entirely comparable risk-shifting instruments. Options on stock and commodity futures have the same purpose and effect: the risk of market fluctuations is shifted from those seeking to avoid such risks while holding the underlying stock or commodity to risk-takers willing to assume such risks for compensation. The process is very much like insurance. The two sets of markets allow shifting of market fluctuation risks from those who are "risk-averse" to those willing to accept risk for the compensation that it provides. Following the insurance analogy, the option buyer, like an individual buying insurance, purchases protection against risk. The option seller like the insurance company, accepts that particular risk.

The two sets of markets directly compete with one another in some areas—both options and commodity futures are presently sold on Treasury bills, Treasury bonds, foreign currencies, the S & P 100 index, and the S & P 500 index. The extent of this overlap is growing, and this growth may accelerate. Any change in tax treatment favoring one set of markets over the other will artificially skew this competitive pattern.

More importantly, both markets involve assumption of risks by investors who are willing to take market fluctuation risks for compensation because they are risk-takers, not because of the underlying products involved. They do so by reference to the potential balance of risk and reward in the transaction to them, and this balance does not depend on whether commodities on the one hand, or stock or securities on the other hand, are involved. Obviously the risk of market fluctuation will vary from one particular commodity to another, or one particular stock to another, but the market will provide potential compensation to account for each separate degree of risk involved. Risk-taking investors in an over-all sense are constantly balancing the levels of risk and levels of reward, and they enter into transactions accordingly, in either particular commodities or stocks, as they see a balance in their favor.

Each of these sets of markets is vital to our economy. Public trading in commodities supports business activity in an infinite variety of ways. Public trading in stock and securities is at the heart of business investment and is vital to capital formation.

The market professionals, whether professional commodity futures traders or option market makers such as those in TOPA, make this risk-shifting process work efficiently. In a very real sense, the two sets of markets and the professionals who make them work compete directly with one another. The tax law works most efficiently when it treats the markets and the professionals in exactly the same way.

5. The tax avoidance problem. In recent years, opportunities for unwarranted tax benefits have arisen as a result of commodity futures transactions and from trading in options on stock. As a general tax rule, gains from appreciation in value of property are not taxed until the appreciated property is sold. The sale of property may be deferred at the owner's will. Losses on property which has fallen in value may be recognized at any time by sale of the property. Thus, the opportunity arises to defer gains and accelerate losses, a strategy that becomes enormously more valuable if the gain in the gain property can be preserved, though not recognized by sale.

Applying those general rules to commodity futures transactions and trading in options on stock, strategies have been developed for trading in combinations of commodity futures or options in stock that would appreciate and depreciate at the same time, in roughly the same amounts. If the losing commodity futures or stock options were closed out and the losses paid, general tax rules permitted the taxpayer to deduct the losses.

If the winning commodity futures or stock options were not closed out or sold, general tax rules permitted the taxpayer to defer recognizing the gain, until they were later sold. Thus, a trading strategy could be adopted intentionally to accomplish mismatching of income and deductions between taxable years. Our tax system contains many such mismatches in other areas, but these commodity futures and stock options transactions are unusually serious problems because they are so easy to accomplish and because the opportunities can be readily sold to investors on a widespread basis as a virtually riskless tax shelter opportunity.

In 1981, the Internal Revenue Code was amended to deal with commodity futures transactions. Trading in options on stock was generally excluded from these provisions, however, because it did not seem at that time to be a serious problem. It is now a serious problem and it is time to move stock options into Code § 1092 adopted in 1981 to defer straddle losses, and to move all publicly-traded options into Code § 1256 to accelerate gain, so that proper matching is achieved.

Acceleration of income so that it is taxed before the cash is actually realized to pay the tax is an extraordinary step and requires special tax treatment. Where the accelerated income is readily convertible to cash without market risk, it is justifiable to accelerate the gain if necessary to prevent tax avoidance, so long as a fair rate of tax is imposed on the accelerated gain. A 50 percent rate of tax on income that may not be realized ever, if the price declines, or until a later year, if the price does not decline, is not a fair rate of tax for income not yet realized but accelerated into the current year.

6. Options on stock should be subject to exactly the same tax treatment as commodity futures. Taking these concepts into account, I strongly recommend that you embrace the essential elements of the CBOE proposal. Options on stock should be put into a special tax system to prevent income and deduction mismatching. A generally satisfactory tax system for this purpose already exists—the system enacted in 1981 for commodity futures contracts in §§ 1092 and 1256.

PROPOSAL

Publicly traded stock option contracts and commodity futures contracts are comparable and competitive financial products. The taxpayers who trade these products perform essentially the same economic function. The opportunities to achieve income deferral and long-term capital gain through the use of straddles employing stock options are comparable to the opportunities presented by commodity futures contracts before the enactment of §§ 1092 and 1256. Consequently, the reasons supporting the adoption of those rules for commodity futures contracts apply equally to publicly traded stock option contracts.

1. Listed option contracts and regulated futures contracts are comparable financial products. Publicly traded stock option contracts and commodity futures contracts are comparable and competitive financial products that perform the same economic functions. Options and futures have the same purpose and effect: to shift certain market risks from those who do not wish to accept such risks to those who will accept them to earn the profits, subject to the risk of losses, that they provide. This risk shifting function is accomplished equally through either an option contract or a futures contract.

The similarity of economic function of options and commodity futures is illustrated first by the fact that they directly compete in a number of markets. For example, an investor currently may buy or sell either options or futures on Treasury bills, Treasury bonds, foreign currencies, the S & P 100 index, and the S & P 500 index. In these cases, the underlying product is identical for both the option and the commodity future. Thus, the holder of a Treasury bond can hedge the risk of that investment by selling a commodity future as to the bond or by buying an option on that bond in the option market.

Market forces alone should determine the choice of market or product to achieve the result. Any substantial disparity in tax treatment favoring one or the other type of contract will greatly distort those forces and result in a shift toward the tax favored type of contract. This will decrease the strength and flexibility of our existing capital markets and, in the long run, do harm to the capital formation process.

Of course, options are not currently available for all property on which futures are traded, and futures are not available for all property on which options are traded. Even when the underlying property differs, however, options and futures still perform the same risk-shifting economic function. Both products are used to limit the risk of holding or being obligated to deliver the underlying property. This means, however, that both products are used to participate in market movement, i.e., incur risk, without current ownership of the underlying property. For an investor willing to assume risk for a potential economic gain, the decision whether to enter into an option or a futures transaction does not depend on whether the underlying property is a commodity or a stock; rather it depends on the potential balance between the risk and reward of the transaction. Thus, for example, the high volatility of a particular type of property may entice or repel a particular investor, but he really is not concerned with whether that volatility is generated by wheat, corn, or stock. The risk-assuming investor simply looks for a particular risk and reward level, and uses options for futures to obtain that level.

Similarly, a risk-averse taxpayer holding a long wheat position and a long stock position may hedge the wheat with futures and the stock with options. The taxpayer does not adopt the positions in futures and options because he wants to possess futures or options, but because they are the best available means to achieve his risk-limiting purpose. His counterpart who holds the offsetting futures and options positions, however, undertakes the risks inherent in those positions for the potential rewards he may obtain. If options were available on wheat, and futures were available on stock, the risk shifting could occur with either product, as is the case with a growing number of types of underlying property.

The key factor is that it is vital to our economy that we have strong markets for public trading in commodities and in stock and securities. It has become equally vital, however, that these markets provide a method of shifting risks or market fluctuations from owners of commodities or stock or securities to investors who are risk-takers for the profits they may earn from such risk-taking activity. In both cases, there must be professionals in the exchanges to make this risk-shifting process work efficiently—commodity futures traders in the commodity markets, and market makers in the options markets.

It makes no sense for the tax law to favor one risk shifting product over another. Currently, however, options and commodity futures are subject to different tax treatment. Futures are marked to market and taxes as 60 percent long-term and 40 percent short-term capital gain or loss. Options are not marked to market but are treated as short-term capital assets to investors and ordinary income or loss assets to market makers. This disparate tax treatment unavoidably distorts market decisions and impedes the efficiency of the capital markets. Any increase in the disparity in favor of commodity futures will simply accelerate an already-existing trend to widen the types of underlying property interests on which commodity futures are traded. To achieve neutrality, the tax law must treat options the same as futures: options should be marked to market, and the resulting gain or loss should be 60 percent long-term, 40 percent short-term.

2. The nature of taxpayers trading futures and options provides no basis for diparate tax treatment. There is no inherent difference between members of the investing public who enter into futures transactions and those who enter into options transactions. Both are simply participating in risk shifting ventures in one product or the other because of its availability or, where choice exists, because of their assessment of the comparative risks and rewards.

Similarly, professional commodity traders and professional option traders perform equivalent economic functions. Each of such groups makes a market by actively trading on exchange floors, thereby providing an orderly and liquid market for investors in accordance with the rules and regulations of the exchanges or boards of trade, the CFTC and the SEC. Historically, however, the options market maker has been treated as a dealer receiving ordinary income and loss while his counterpart in the commodity pit has received capital gain or loss. Analysis of the conceptual basis for this treatment suggests no sound reason for it. In any event, there is simply no reason to perpetuate this distinction in tax treatment between professional commodity traders and option specialists.

3. Futures and options present comparable opportunities for tax benefits, and the preventive rules should be the same. Sections 1092 and 1256 were enacted to prevent taxpayers from obtaining certain tax benefits through the use of straddle transactions, primarily in futures contracts. Commodity straddles presented the opportunity to defer tax on short-term capital gain from one year to the next, and in some cases, to convert short-term capital gain realized in the first year to long-term capital gain in the later year. Additionally, straddles in futures on Treasury bills could be used to defer ordinary income and convert that income into capital gain.

In a simple futures straddle, the taxpayer would enter into offsetting long and short positions intended to largely insulate him from economic loss. Any market movement in the underlying commodity would create a gain in one leg of the straddle and a corresponding loss in the other leg. The taxpayer could then liquidate the loss leg in the first year, creating a deductible capital loss, while deferring recognition of the gain leg until the following year. The loss could thus be used to reduce tax for the first year and defer that tax until a later year. Furthermore, gain from a long futures position was eligible for long-term capital gain treatment if held for more than six months, so that if the gain occurred in the long leg of straddle, the deferred gain could be converted from short-term capital gain into long-term capital gain.

The opportunity to defer ordinary income and convert it to capital gain arose from straddles in futures on Treasury bills. Prior to 1981, Treasury bills were not treated as capital assets, but any futures contract in Treasury bills was a capital asset. As a result, the taxpayer could enter into a straddle in Treasury bill futures, and, if the loss appeared in the contract for purchase of the Treasury bill (the "long leg"), take delivery of the bill on such loss leg and sell the bill for an ordinary loss. He could then terminate the gain leg in the futures market for a capital gain in the following year.

The use of futures straddle to obtain these tax benefits was addressed in 1981 by the enactment of §§ 1092 and 1256. The "mark to market" regime imposed by § 1256 was enacted to prevent the selective recognition of gains and losses in futures that is essential to achieving a tax benefit from the straddle transaction. Enactment of § 1092 was necessary because § 1256 was applicable only to straddles involving regulated futures contracts (or, in the case of an "identified mixed straddle" involving other property, to the regulated futures contract elements of the mixed straddle where the taxpayer does not elect otherwise). Section 1092 generally requires the deferral of any loss which is offset by an unrecognized gain in an "offsetting position."

Section 1092 is, in reality, a back-up provision to insure that to the extent § 1256 does not require marking to market, there still can be no loss taken where a gain in an offsetting position exists. There was general recognition in 1981 among experienced tax counsel that without the mark to market rules of § 1256, § 1092 standing alone could never be administered in practice to prevent sophisticated straddle transactions.

Since the mark to market system accelerated the recognition of gain and reduced other tax benefits that flow from the traditional recognition concept, the top tax rate on futures contracts was effectively lowered from 50 percent to 32 percent by treating the mark to market gain or loss as 60 percent long-term and 40 percent short-term capital gain or loss.

Publicly traded stock option contracts currently are not subject to the mark to market system. They are not "regulated futures contracts," and listed stock options are specifically exempted from the application of the loss deferral rules in § 1092. However, the possibility of deferring gain from one year to the next through straddles in stock options is equivalent to that presented by straddles in futures before the 1981 legislation. Since stock options are not marked to market, taxpayers are able to adopt balanced option positions and selectively recognize the loss legs while deferring recognition of the offsetting gain. Since § 1092 does not apply to stock options, the loss may be deducted currently.

It also appears that a long term capital gain conversion possibility is presented by straddles in options on commodity futures contracts. (There is an unresolved dispute at the present time as to whether such options in commodity futures are subject to § 1256). If the gain appears in the long leg of the straddle, the taxpayer arguably realizes 60 percent long-term capital gain by exercising his option to acquire the commodity futures contract and subsequently terminating such futures contract, or by marking it to market (since the futures contract itself is clearly subject to § 1256). The corresponding loss on the commodity futures option would then be realized by closing out the option in the earlier year creating short-term capital loss. Thus, this transaction is comparable to the straddle in Treasury bill futures which was prevented in 1981.

A straddle in offsetting stock option positions can reach a similar result. After the market has moved to generate offsetting gains and losses, the taxpayer can close out the loss leg to recognize short-term capital loss. By exercising the gain leg to obtain the stock itself, recognition of the gain can be deferred indefinitely. If the stock is held for more than one year, the gain can be recognized as long-term capital gain.

These tax benefits are essentially the same as those obtained with commodity futures contracts prior to 1981. All of these tax benefits can be prevented by recognizing that all publicly-traded options (options on stock or other securities and options on commodities or commodity futures contracts) and commodity futures transactions involve comparable products with comparable uses and should be subject with equal effect to the tax rules of §§ 1092 and 1256.

4. The application of § 1092 standing alone would not provide sound tax treatment for stock options. The application of § 1256 and § 1092 (improved as hereinafter provided) to all publicly traded option contracts would provide a fair and effective tax regime. It would effectively prevent deferral of gain, as well as the potential for converting short-term capital gain into long-term capital gain through straddles. It would be fair and effective, also, because it would provide neutrality of tax treatment for comparable financial products. This is essentially the CBOE proposal

which TOPA endorses. The extension of § 1092 standing alone to stock options would be highly anti-competitive—as between products, exchanges and market makers. Furthermore, it would not effectively prevent tax motivated transactions.

If the loss deferral rule contained in § 1092 alone were applied to market makers, without § 1256, it is likely that in practice the IRS would attempt to tax market makers to a substantial extent on gross receipts rather than net income. Recognized gains would always be taxable, but the IRS would seek aggressively to defer losses on the ground that the hedging exemption to § 1092 did not apply, and that offsetting unrecognized gains exist. Market makers have such an extraordinarily high volume of transactions, and such a large number of open positions at any given time, including year-end, that it is conceivable that an open position with unrecognized gain could be found for many positions in which the market maker took a loss for the year. There would be unending controversy as to the extent to which these positions were entitled to the hedging exemption from § 1092 or were "offsetting" within the scope of § 1092. The likely result would be that the IRS would attempt to tax the market maker on all his recognized gains without allowing an adjustment for all of the losses which produced such gains.

To avoid this result, the market maker would be forced in practice to liquidate his open positions at year-end in order to obtain a tax result that accurately reflected his economic position. The effect of all market makers attempting to close out all their open positions at year-end would be to distort market prices very seriously. It would threaten the market makers with economic loss from forced sales. It could potentially destroy orderly and efficient options markets and adversely affect the stock markets. The capital formation benefits of efficient option markets (supra pp. 2–6) would be lost.

Moreover, the loss deferral rules of § 1092 alone will not be effective to eliminate existing tax avoidance opportunities. The effectiveness of those rules is entirely dependent upon the ability of the taxpayer, or the government on audit, to identify and trace specific offsetting positions. Each market maker has his own strategy and makes his own determination of what positions are sufficiently balanced to bring his risk of market movement within tolerable limits, based on assumptions as to volatility and other factors. It is highly unlikely that an astute market maker's concept of balanced positions will coincide with the definition of "offsetting positions" under § 1092.

As a result, positions that a market maker considers balanced may not be "offsetting" within the somewhat uncertain meaning of that concept in § 1092. Conversely, given the very high volume of market maker activity and the large number of open positions at any given time, it is highly likely that transactions the market maker views as entirely independent will contain individual positions that, viewed in combination, will be considered offsetting by the IRS under § 1092. No market maker can reasonably be expected to correctly match these positions, particularly because sensible implementing regulations will be impossible to write. Moreover, many market maker firms have numerous employees, each of whom is responsible for assuring limited risk only with respect to his own positions. It is entirely likely that particular positions of a market maker firm would not be offsetting under § 1092, viewed from the standpoint of the positions of a given employee. In fact, however, a market maker firm's risk-hedging operations are so complex and extensive, based on sophisticated computer determinations ranging over a broad scope of individual transactions, that such positions indirectly may be offsetting (i.e., the risk has been eliminated) because of positions taken by other employees.

Even more practical problems exist. As prices of stocks and options move up and down, the degree to which particular positions offset or diminish the risk of loss will change. Market makers routinely change their positions as markets move and as their risk assessment changes. Consequently, options positions (or option and stock positions) which were not balanced (and surely were not offsetting within the meaning of § 1092) at the time they were entered into may move into technically offsetting positions later. For example, a call option at a strike price of $100 does not protect against a risk of loss in a stock position (in excess of the call premium) when the stock is selling at $100. If the stock price rose to $125, however, the call option at $100 would afford significant loss protection. Conversely, originally balanced or offsetting positions may move into nonoffsetting positions later. These constantly changing price relationships magnify by geometric proportions the difficulty of applying § 1092 to market makers. Moreover, sophisticated risk balancing techniques may not match positions on a one for one basis, but rather, as previously suggested, on a complex ratio based on an assessment of risk related to volatility and other factors.

These problems simply do not exist in anything like the same degree with respect to commodity futures transactions. In addition, there are many more stocks and bonds than commodities, the trading techniques are different for market makers and commodity futures traders and the system of premiums for options does not exist for commodity futures.

In light of these considerations, I respectfully and earnestly submit that an extension of § 1092 in its present form to options on stock, without extension of § 1256, would be a serious mistake. The specific identification and tracing of offsetting positions required by § 1092 would be impossible to administer fairly and comprehensively with respect to option market makers. It would not provide an accurate reflection of a market maker's economic position, and it would unwisely compel the closing of open positions at year-end. I strongly urge that the solution is to mark all options to market at year-end under § 1256, with the addition of the TOPA proposal discussed below.

5. No revenue loss results from 60/40 treatment for options on stock. The options market, like the commodities market, is essentially a "zero sum" system because there are as many losses as gains in option transactions; for every winner there is a loser. Although the system is not perfectly symmetrical, the asymmetries are estimated not to cause either revenue gains or losses sufficient to change significantly the "zero sum" result. Therefore, the rate to be applied to mark to market gains should be determined by equity, and equal products should have equal rates. No revenue loss will result from treating gains and losses on options on stocks as 60 percent long-term capital gain, 40 percent short-term capital gain, just as commodity futures transactions are treated under § 1256. This yields an effective tax rate of 32 percent for virtually all such transactions.

The 32 percent tax rate established in 1981 for commodity futures contracts represented a Congressional determination of a fair tax rate for a mark to market system in which gains and losses were accelerated as of each year end. It would be equally fair to provide such a tax rate in a mark to market system for options on stock. It is essential to preserve competitive neutrality, a level playing field, inasmuch as it has previously been shown (supra pp. 4-6, 9-12) that commodity futures compete with options for available capital.

The adoption of a 32 percent rate when § 1256 was enacted recognized that the mark to market system significantly disadvantaged commodity futures traders as compared to traders in other types of property. The same considerations apply as to options on stock. As stated above, the mark to market regime accelerates the recognition of gains by requiring annual recognition regardless of whether the positions remain open. The taxpayer thus does not have the ability of all other taxpayers to delay sales and thus the recognition of gain until a later year. Additionally, since the mark to market regime treats the exercise of an option as a taxable event, it forecloses the opportunity to exercise an appreciated option into the underlying stock and then to defer recognition of the gain. Furthermore, the automatic treatment of losses as 60 percent long-term and 40 percent short-term capital loss, without regard to a holding period, creates a further disadvantage for a taxpayer with both long and short-term capital gains, because the long-term capital gain will be reduced by the long-term portion of the 60/40 loss.

These and related considerations demonstrate that a tax rate of 32 percent is fair for publicly traded option contracts. As pointed out earlier, options and futures are comparable financial products, and it would be extremely inequitable and inefficient to favor the futures market over the options market by imposing a higher rate on options than that imposed on futures. It is important to the integrity of both capital markets that investors be left to make market decisions uninfluenced by arbitrary tax distinctions.

6. Additional proposal for market makers. As set forth above, TOPA does not believe that it is practical to apply existing § 1092, which requires specific identification and tracing of offsetting positions, to option market makers with large volumes of transactions in options, stock and securities. Accordingly, TOPA proposes that the CBOE proposal be augmented to permit market makers to "shortcut" the tracing rules of § 1092 by considering all options positions positions and all positions in the underlying stock or securities to be offsetting positions. It may be possible to achieve through Treasury Regulations an administratively simple system that would satisfactorily permit options market makers 60/40 treatment for options gains. It the alternative, TOPA believes that the legislative rule described below would be acceptable to market makers. It is entirely faithful to the principles of § 1092, with the advantage that it is administratively feasible. While it does not acheive a theoretically perfect result, it contains no bias favoring market makers. A theoretically perfect result is impossible to achieve.

a. Need for a rule of convenience.—Loss deferral rules, such as those contained in § 1092, are unnecessary for any pure option straddles within the mark to market regime, because gain and loss are recognized on both sides of the straddle at year-end. Loss deferral rules are required, however, for mixed straddles (when the election to exclude mixed straddles from 60/40 treatment is not made), because gain in the underlying property is not recognized under the mark to market system. Therefore, a taxpayer, while being forced to recognize the mark to market option losses, can defer offsetting gains in the underlying property.

Similarly, under a mark to market regime (the CBOE proposal), gain or loss on option, but not gain or loss on the underlying property, would be treated as 60 percent long-term and 40 percent short-term capital gain or loss. The more favorable 60/40 treatment of options would provide an incentive for a taxpayer who would recognize short-term capital gain or loss on the underlying property to attempt to "convert" such short-term gain on the underlying property into 60/40 gain on options. If offsetting positions can be combined in such a way as to absolutely assure the generation of a 60/40 gain and a corresponding short-term loss, while insulating the taxpayer from market risk and the risk of creating an adverse tax effect, the taxpayer will be able to "convert" the existing short-term gain into 60/40 gain.

The CBOE proposal attempts to eliminate this possibility in a manner consistent with the rules currently applicable to regulated futures contracts. Thus, under the CBOE proposal, mixed stock and options straddles generally would be subject to the loss deferral rules of § 1092, which require the deferral of losses to the extent of unrecognized gain in an offsetting position. Similarly, the CBOE suggests that one method of preventing the conversion of short-term gain into 60/40 gain through mixed straddles would be to net the gain or loss from an option with the gain or loss from an offsetting position in the underlying property.

Although this approach generally reaches theoretically desired results, it is based upon an unworkable foundation for market makers. As previously discussed, it is impracticable for market makers, or the Internal Revenue Service on audit, to define, identify daily and trace until disposition all of the stock and options positions that may be offsetting.

Therefore, TOPA proposes to permit a market maker to "shortcut" these tracing requirements by considering positions that may not be, or in fact are not, offsetting positions as if they were offsetting.

b. The shortcut rule.—Market makers should be permitted to establish a trading account, by identifying positions to that account on the day acquired. These positions could include listed option contracts, regulated futures contracts and the property underlying those contracts. Options (and regulated futures contracts) in that account would be marked to market and taxed as 60 percent long-term, 40 percent short-term gain or loss. Gains in underlying property would be accelerated to be offset against 60/40 losses. Gain or loss from the underlying property would always be short-term capital gain or loss.

Adoption of TOPA's approach would eliminate any potential for income deferral through the selective recognition of losses. Furthermore, this approach, together with a few special rules, would eliminate any ability to combine option and other positions in a manner that would convert short-term capital gain to long-term capital gain.

This simplified approach to the offsetting position concept would permit the taxpayer to decide which positions would be deemed offsetting, and to isolate those positions in his mark to market trading account. Market makers would have a strong incentive to identify all their option positions together with their positions in the underlying property in their trading account because of the certainty that would result. The market maker also would be required to include all offsetting positions in that account. Any positions not in the account which offset a position in the account could be brought into the account on audit by the IRS.

This proposed rule is far simplier to apply and enforce than current § 1092, yet it effectively achieves the goals of that section in preventing the deferral of income or the conversion of short-term gain into long-term gain through mixed straddles. It provides no benefit to the market maker except certainty of tax consequences. It accelerates gains, and gains and losses in the underlying property would always be short-term capital gain or loss.

c. Prevention of income deferral.—TOPA's proposal is far more effective than § 1092 in eliminating the possible use of mixed straddles to defer income through the creation of artificial losses. Because the proposed rule requires the recognition of otherwise unrecognized gain in any underlying property to offset any 60/40 loss, a 60/40 loss generated by a mixed straddle will be absorbed and will not be available to offset other gains. As this result occurs mechanically within the trading account, regardless of whether the positions actually offset, deferral of income is prevented without the need to determine whether those positions in fact are offsetting positions.

Stock or other property subject to § 1092 held outside the trading account would not be subject to this treatment unless such positions in fact offset a position within the account. As mentioned earlier, most market makers would have a strong incentive to place their positions in the trading account to achieve certainty. A market maker would not be likely to leave outside the account positions that were in fact offsetting, because to do so without reasonable basis would subject him to penalties for negligence or substantial understatement.

d. Conversion prevention.—As noted earlier, the more favorable 60/40 treatment of options could provide an incentive for a taxpayer who realized short-term capital gain to attempt to "convert" it into long-term capital gain on options. That is, if a taxpayer can use a mixed straddle to safely produce an option gain and a securities loss, the loss could be used to eliminate a preexisting short-term gain with the effect of "converting" that gain into 60 percent long-term gain (40 percent short-term gain) from options.

TOPA's proposal prevents this conversion possibility very effectively by requiring recognition of otherwise unrecognized gains in underlying property as short-term gain. A taxpayer with both short-term and long-term gains can only safely attempt to convert the short-term gain into long-term gain by adopting a position consisting of a combination of offsetting mixed straddles. Using this strategy, a taxpayer might offset a long stock position with option positions and adopt a corresponding short stock position also offset by options. This is called a "conversion and reversal". The risk of market movement would be neutralized if done correctly: that is, whichever way the stock moved the taxpayer would realize precisely offsetting gains and losses in his stock and options. Use of such combinations assures, therefore, both a gain and a loss in stock with a corresponding gain and loss in options if the market price of the stock moves. If a taxpayer chose not to sell the stock, the offsetting option loss would be deferred under § 1092 (assuming it were made applicable to options on stock). The taxpayer would then have achieved a short-term stock loss (available to reduce the pre-existing short-term gain) and a matching 60/40 option gain. He would also have a short-term capital gain in the stock in the conversion and reversal, but this gain would not be marked to market under the current § 1256 rules. The result would nonetheless be to convert the pre-existing short-term gain to a 60/40 gain. Such a conversion of short-term gain to 60/40 gain could always be achieved so long as the underlying stock either increased or decreased sufficiently in value.

TOPA's proposal renders such combinations useless because it accelerates the otherwise unrecognized stock gain in the combination, causing the gains and losses to offset each other for tax purposes, leaving the transaction without effect while burdening the taxpayer with transaction costs and commissions. Accordingly, the application of TOPA's proposed rule removes the ability of any taxpayer to attempt a risk-free conversion of short-term gain into 60/40 gain.

The proposed rule does not mechanically prevent the attempted use of a single mixed straddle, rather than the combination discussed above, to generate short-term loss and 60/40 gain. However, a taxpayer with a long-term gain who enters into a single mixed straddle transaction runs a very substantial risk of the market moving the wrong way, thereby creating additional short-term gain with an offsetting 60/40 loss which would reduce or eliminate existing long-term gain. This is the reverse of the conversion problems to which the TOPA proposal is addressed. The impracticality of attempting to convert any substantial amount of short-term gain through a single straddle, coupled with the risk of a wrong-way conversion, prevents the single combination from presenting a realistic method of reducing tax liability when the taxpayer otherwise has long-term gains. As stated above, market makers will always have substantial long-term gains under a 60/40 rule, as well as short-term gains.

Although TOPA does not believe that realistic conversion potential exists through the use of single mixed straddles, TOPA's proposed rule nevertheless provides an additional safeguard that prevents any significant conversion potential. This special rule provides that in no event is the net gain (from options and securities) from the trading account to consist of more than 60 percent long-term capital gain. As a result, the generation of additional long-term gains within the account in excess of the 60/40 ratio provided for options generally would be of no benefit to the taxpayer, because such a gain will be recharacterized as a 60/40 gain.

CONCLUSION

The CBOE proposal should be adopted. The existing markets for options on stock play a vital role in increasing the efficiency of our capital markets, and thus in the capital formation process. They serve as the medium for risk-shifting, just as the commodity futures markets serve this function. There is an increasing trend in the commodity futures markets to provide for the shifting of risks as to stocks and securities, so that the two sets of markets trade products that compete directly with one another. This is a healthy competition, increasing the efficiency and flexibility of our capital markets. The tax treatment of both markets should be the same so as not to interfere with this healthy growth in institutions for risk-shifting. The CBOE proposal would provide equality of treatment for both markets while preventing tax avoidance opportunities.

Option market makers exist to make the markets for options on stock work efficiently. They are entitled to the same tax treatment as professional commodity traders, who serve the same functions for commodity markets. It would be a serious error to adopt § 1092 for options on stock without a mark to market system for such options and 60/40 tax treatment. Section 1092 will not work for option market makers. A mark to market system for them is essential, and a mark to market system, which accelerates their net income, calls for 60/40 treatment to achieve fairness, just as was the case in 1981 for commodity future transactions.

TOPA proposes in this statement an addition to the CBOE proposal to make the § 1092 principles workable for option market makers. It confers no benefits on them; it is a rigorous rule which prevents the deferral of income and the conversion of short-term gains to long-term gains. It is an administratively feasible alternative to the indentification and tracing of offsetting positions required by § 1092 and effectively achieves the goals underlying that section. I strongly recommend that the CBOE proposal be adopted with the TOPA addition.

Finally, I reiterate the CBOE's entirely reasonable request for transition relief. The initiation of a mark to market system will inevitably cause distortions in taxpayers' liabilities by accelerating income into the year the system becomes effective.

The mark to market rules provide a reasonable tax system, but they also represent a radical departure from traditional gain recognition principles. As a result, it is only reasonable to provide for a smooth transition to the new system by including tax rate and interest relief provisions for the income accelerated by the new rules.

The necessity for transition rules was recognized in 1981, when §§ 1092 and 1256 were originally enacted, but disputes subsequently have arisen between taxpayers and the IRS as to the scope of the transitional rules. I respectfully suggest that a transitional rule that produces disputes is not in the best interests of sound tax administration. However, there must be any number of other transitional rules that would equitably serve both taxpayers' and the government's interest in assuring a smooth transition to the new system while preventing endless future disputes. It would appear that the competing concerns involved could be accommodated by a rule that permits a taxpayer to accelerate all his income into the year the legislation is enacted, through the mark to market rules, and to pay the resulting liability at a 32 percent rate over a five year period. Since the tax on this income would be paid at a reasonable rate over a reasonable period, the rule also should preclude any attempted reallocation of income recognized under the transition rule to a different taxable year.

An approach such as this would provide for a smooth and equitable transition to the new system while preventing needless disputes and the accompanying waste of resources.

Mr. ANTHONY [presiding]. Thank you, Mr. Nolan.

Mr. Duncan, do you have an inquiry?

Mr. DUNCAN. I have no questions. I would like to thank the panel. I know you are always very helpful and I hope we can reach some conclusion on this matter soon.

Mr. ANTHONY. Mr. Nolan, could you very quickly educate me so that it will be in the record? What is the mechanism used by somebody that would like to use the options to create a tax avoidance or a tax deferral?

Mr. NOLAN. Well, they take offsetting positions in the same security through the options market. When the market moves there will be a loss in one of those positions and a gain in the other position. The taxpayer will then liquidate the loss position and realize the loss to offset other gains. The taxpayer will not liquidate his gain position but defer the gain position to a future year.

Mr. ANTHONY. If the committee moved in this area and passed legislation and adopted your position, do you think that would clean up the possibility of having tax avoidance schemes completely? Or do we not still have the possibility of a situation where you could have mixed straddles out there?

Mr. NOLAN. We think it would clean it up completely, Mr. Anthony. We propose basically a mark-to-market system in which all gains and losses would be recognized at year-end. In mixed straddles, where that rule would not be applicable, we would retain the application of 1092, which is the provision that was enacted in 1981 to deal with the mixed straddle problem in the case of commodity futures. We are not suggesting that that not be made applicable. That would still be a backup, just as it is under present law with respect to commodities futures transactions. In our case, in the case of the Options Policy Association, we have suggested in our statement special rules to make certain that those offsetting position rules in section 1092 will work very effectively for option marketmakers. We are quite convinced that the total package that we propose will stop the tax avoidance, even with respect to mixed straddles.

Mr. ANTHONY. So from an administrative standpoint you think that it is doable and workable?

Mr. NOLAN. We think it is not only doable and workable, but we think it is absolutely important from an administrative standpoint that you adopt the mark-to-market system that the CBOE and we recommend so strongly. Coupled with that mark-to-market system has to be a 60–40 tax treatment in order to be fair to us, just as you treat the commodities futures transactions.

Mr. ANTHONY. Mr. Thompson, do you have a comment?

Mr. THOMPSON. Yes, Mr. Anthony. I would like to address that question.

We think that the proposal of the CBOE is the most rational way of approaching this problem. It shuts down all of the deferral opportunities that we are aware of. There is the mixed straddle issue, however, because if stock options are treated as regulated futures contracts, then a straddle between a stock option and stock would be subject to the mixed straddle rules that are currently in the law.

But those rules are designed to prevent deferral and prevent conversion. Unfortunately, the Treasury has not promulgated regulations dealing with mixed straddles, but we believe at the CBOE that we can work with Treasury in developing a rational set of mixed straddle rules that would apply across the board, that is, would apply to a case where a taxpayer is long corn and acquires—goes short a corn future, or is long a debt security and goes short a debt future.

Problems exist today, but we would work to help Treasury solve the problems. We do not believe that moving stock options into the futures world and giving them regulated futures contract treatment would give rise to any major problems under the mixed straddle provisions.

Mr. NOLAN. Could I just add to that that this is really an extraordinary situation that we have here. The CBOE in August of this year came forward with a complete package on how to deal with a major tax avoidance problem and laid it out as to how it should be done. Both they and our group have worked steadily with the Treasury Department since that time to try to identify all of the tax avoidance possibilities that could arise and the ways that they should be dealt with.

We have come forward with a comprehensive package to deal with the tax avoidance problems. We continue to work with the Treasury Department to try to do that. We are quite certain that we are moving toward a complete solution in this area, and we are quite distressed that the Treasury Department today has accepted some elements of our proposal and not all of it.

Mr. THOMPSON. Mr. Anthony, may I make one further comment about one suggestion in the Treasury proposal this morning—the suggestion that this committee consider the possibility of marking market makers in options, to market and taxing them at 50 percent.

That would be unprecedented. There is no taxpayer who has inventory who is mark-to-market on his inventory gains and losses. To carve out market makers and to apply that harsh rule to them would be patently unfair. If you want to apply that rule to General Motors on its inventory, then there might be a basis for applying it to market makers, but the only place where Congress has imposed the mark-to-market rule that I am aware of is in the commodities area with respect to futures contracts.

And those contracts have traditionally been given capital gains treatment. It so happens that purely by an aberration in the development of the law our products have been given ordinary income treatment for our market makers. We think that it is rational and indeed would be a rationalization of the law to move those products, as we have suggested in our proposal, into the capital gains world and to give them the same 60-40 treatment that the professional commodity trader receives.

Mr. ANTHONY. Well, I want to thank you for your testimony and participation in establishing a record on this. As one who has made four trips to Chicago to try to learn more about the fast movement and the evolution that is taking place in the financial industry, I find it fascinating, and at the same time, very complicated because of the many different financial instruments that are being created every day.

I personally applaud you for stepping forward and doing two things—trying to bring some tax equity into the code and, more particularly, attempting to address the problem on tax avoidance. Thank you.

Our next panel will be the Commodity Exchange, Inc., Alan J. Brody, president, accompanied by Jeffrey Cole, tax counsel; Coffee, Sugar & Cocoa Exchange, Inc., Donald Schapiro, accompanied by James J. Bowe, senior vice president.

STATEMENT OF JEFFREY COLE, TAX COUNSEL, COMMODITY EXCHANGE, INC., ON BEHALF OF ALAN J. BRODY, PRESIDENT

Mr. COLE. Mr. Chairman and members of the committee, I would like to request that our written submission be placed in the record.

Mr. ANTHONY. Without objection it will be placed in the record.

Mr. COLE. I regret to inform this committee that Mr. Alan J. Brody, president of the Commodity Exchange, Inc., in New York City, popularly known as the Comex, is unfortunately unable to appear and I will be making the statement instead. My name is Jeffrey Cole. I am a member of the law firm of Baer Marks & Upham in New York City. We are counsel to Comex.

Comex specializes in precious and industrial metals—gold, silver, copper, and, soon, aluminum as well. We do not trade any futures contracts on on securities or security-type products such as stock indexes. Comex has made a conscious decision to concentrate on metals and other hard or traditional commodities.

Comex is the world's largest metals market. In the United States it accounts for 90 percent of all silver futures trading, 95 percent of all gold futures, and 100 percent of all copper futures transactions.

Approximately 1 year ago Comex expanded its service to the metals industry by initiating trading in an option on the Comex gold futures contract. This is one of only two hard commodity options now being offered, the other being an option on sugar futures at New York's Coffee, Sugar & Cocoa Exchange.

When the Economic Recovery Tax Act of 1981 was passed, a completely new regime of taxation was adopted for regulated futures contracts, which I will refer to as RFC's. In general, gains and losses on such RFC's are treated as 60 percent long-term and 40 percent short-term capital gain or loss, that is the 60-40 rule.

As Comex gold future contracts qualify as RFC's under the code, it is our position that all gain and loss with respect to options on these RFC's should be taxed under the same tax regime—that is, under the 60-40 rule. We are pleased to hear today that Treasury also supports our view and that the Senate Finance Committee also shares our view.

We believe our position is mandated under current law and is in full accord with congressional policy, as expressed in the Economic Recovery Tax Act of 1981. Any other Federal income tax treatment for RFC options will create opportunities for tax shelters and tax abuse activities in commodity transactions.

These activities would deprive the government of much-needed revenues, would disrupt the commodity markets, would create uncertainties in ascertaining the tax consequences of transactions in commodities, and would create tax results which are inconsistent with the underlying economic realities of the transactions involved.

The tax rules enacted by Congress in 1981 are sound. They have provided much certainty in ascertaining tax consequences of futures transactions, and have curtailed attempts by taxpayers to use the futures markets to engage in tax avoidance transactions.

We believe our position regarding the current Federal income tax treatment of the RFC options further reduces the potential for tax avoidance transactions.

As you just heard, certain representatives of the securities industry have submitted proposals suggesting that their exchange-traded options, such as options on stock, on debt, on currency, and on indexes, be taxed in a similar fashion as the RFC options—that is, under the 60–40 rule. This purports to create a so-called level playing field.

We should stress that where options do not compete, where a level playing field is not required in order to create equity among rivals, the call for a similar tax structure loses its persuasiveness. Comex's options on gold futures pose no realistic threat to stocks, bonds, securities options, or stock indices in the marketplace.

It and the option on the sugar futures mentioned earlier are far more akin to the futures contracts on those hard commodities than to any of the financial instruments offered by the securities exchanges. Nor will the pending and anticipated RFC options in the area of metals, energy or agriculture be in competition with the securities options.

Aside from the fact that these two classes of options are noncompetitive, we should emphasize that the proposals to alter the tax treatment of the securities options—that is, to give those options a 60–40 tax treatment—and the property which underlies those options to have the applicable capital gains rules would create, as previously stated by Treasury, a dramatic increase in the potential for tax straddling and tax abuse activities.

Congress would have to focus very carefully on formulating rules to prevent this increase in tax shelter activity before it could even seriously consider these proposals.

In concluding, Mr. Chairman, our position is simply that the tax treatment of an option, whether it be a commodity option or a security option, should be based on the tax treatment of the property which is the subject of the option. We believe this result is mandated under current law. Any change in the law which would provide a different tax regime for the RFC options and the RFC's which are the subject of such options would encourage attempts by taxpayers to engage in tax shelter activities which would cause disruption of the commodity markets and would produce tax results which are not in accord with economic realities.

We thank you for the opportunity to present our views to the committee.

[The prepared statement of Mr. Brody follows:]

STATEMENT OF ALAN J. BRODY, PRESIDENT, COMMODITY EXCHANGE, INC., NEW YORK, N.Y.

I. INTRODUCTION

Mr. Chairman and members of the Committee, my name is Alan J. Brody and I am President of Comex, or Commodity Exchange, Inc. as it is formally known. I have been associated with the Exchange for the past four years, first as outside counsel, then as general counsel and, for the past two years, in my current position as President.

In coming before you I emphasize the name of the Exchange I head—Commodity Exchange—because it is commodity futures that we at Comex deal in. Founded fifty years ago, through the merger of four pre-existing commodities markets, Comex has historically specialized in the trading of hard commodities.

When Comex was formed in 1933 silver and copper futures, among other products, were traded. Since then, gold futures and options on Comex futures contracts in gold have been added to the Comex product list and, pending approval by the Commodity Futures Trading Commission ("CFTC"), aluminum futures will soon be added.

As Comex has evolved, it has become the world's most active metals futures market. Comex is the only market for copper futures in the United States. Of all the gold futures contracts traded in this country, more than 95 percent are traded on Comex. The Exchange also accounts for more than 90 percent of the silver traded on U.S. futures markets. In addition, upon approval of the pending Comex aluminum contract, we will be the only market for such futures contracts operating in North America.

Comex contracts have become international in nature, attracting participants from around the world. The introduction of Comex gold futures in 1975 and their rapid volume growth has resulted in New York becoming the world's center for gold trading.

Within the spectrum of the growing financial services industry, the growth of the futures industry over the past decade has been nothing short of spectacular. In 1973, less than 26 million contracts were traded on U.S. futures exchanges. In 1983, that number will likely exceed 120 million contracts.

The rate of growth for Comex has been even greater than that for the industry as a whole. In 1973, less than 2 million contracts were traded at Comex, accounting for 8 percent of the national futures market. This year, the Exchange should record a volume of approximately 20 million contracts, accounting for more than 15 percent of the national market.

The growth of our markets can be attributed to the fact that Comex offers individuals and organizations from around the world the opportunity to participate in an open and efficient commodities marketplace. Additionally, we feel that each of our contracts serves a real and important function for industry. This is borne out by the fact that nearly 50 percent of the open interest in each of our contracts is held by commercial hedgers—organizations or individuals needing to insure the price they will receive or pay for a given commodity. Due to the heavy participation in each of our markets by hedgers, as well as speculators, Comex has become the primary source for worldwide pricing information in each of our contract areas.

What is true for our futures markets is also proving true for our gold options market, and should prove true for a soon to be proposed Comex market for options on silver futures.

Since their introduction 13 months ago, options on Comex futures contracts in gold have more than doubled their average daily trading volume to 3,000 option contracts per day, and open interest in the contract has steadily climbed and now exceeds 32,000 contracts. As with gold futures, options on Comex futures contracts in gold are heavily utilized by commercial hedgers. Both our current and proposed option contracts offer the opportunity for risk insurance to those who deal in physical metals.

We at Comex feel that our ability to provide a trading facility for the transfer of price risk by hedgers in metals has enabled Comex to become the dominant center in the world for metals trading.

II. SUMMARY OF COMEX'S POSITION

Mr. Chairman, it is my pleasure to be appearing before the Committee to present the views of Comex concerning the Federal income tax treatment of options on Comex regulated futures contracts in gold (all options on regulated futures contracts are sometimes hereafter referred to as "RFC options" or "RFC option").

The Economic Recovery Tax Act of 1981 ("1981 Tax Act") adopted a completely new regime of taxation for regulated futures contracts traded on a U.S. board of trade or exchange ("RFCs"). In general, all such RFCs are treated as sold at their fair market value on the last day of the tax year and any gain or loss is taken into account for the taxable year.[1] In addition, this mark-to-market rule is also applicable to the termination or transfer during the tax year of a taxpayer's obligation or rights with respect to RFCs by offsetting, by taking or making delivery, or otherwise.[2] Gains and losses on such RFCs are treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss ("60/40 rule").[3] Since the maximum effective tax rate on individuals is 50 percent, the maximum effective tax rate on an individual's income from RFCs is 32 percent.

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[1] Section 1256(a)(1) of the Internal Revenue Code of 1954, as amended. Section references hereafter are to the Internal Revenue Code.

[2] Section 1256(c).

[3] Section 1256(a)(3).

On October 4, 1982 trading began in options on Comex futures contracts in gold. All Comex futures contracts as to which options are traded qualify as RFCs under Section 1256(b). It is our position that all gain and loss with respect to these RFC options is also taxes under the 60/40 rule.

We believe our position is mandated under current law and is in full accord with Congressional policy as expressed in enacting the 1981 Tax Act. Any other Federal income tax treatment for RFC options would create opportunities for tax shelter and tax abuse activities in commodity transactions which would deprive the Government of much needed revenues, would disrupt the commodity markets, would create uncertainties in ascertaining the tax consequences of transactions in commodities and would create tax results which are inconsistent with the underlying economic realities of the transactions involved.

More specifically, it is our position that the current Federal income tax treatment of speculative RFC options is as follows:

1. All gain and loss taken into account by holders and grantors of RFC options is taxed as 60 percent long-term and 40 percent short-term capital gain or loss without regard to the actual holding period of the option.[4] This tax treatment conforms to the tax treatment of the RFCs which are the subject of the RFC options.

2. Grantors of RFC options who are required to provide, and who are entitled to receive, variation margin on a daily mark-to-market basis, recognize gain or loss on termination of their obligation under the option by offsetting, by taking or making delivery, or otherwise[5] and on positions open at the end of the tax year.[6] As to grantors, the RFC options are RFCs.[7]

3. Holders of RFC options, with respect to which there is no passing of variation margin, are not subject to the mark-to-market rule.[8] No gain or loss is recognized by holders of RFC options on their exercise and on entry into RFCs. The premium paid for the RFC option is treated as an adjustment when gain or loss on the RFC is recognized. Gain or loss is to be taken into account by holders of RFC options on lapse of the options or on their termination by offset.

The tax rules enacted by Congress in 1981 are sound. They have provided much certainty in ascertaining the tax consequences of futures transactions and have curtailed attempts by taxpayers to use the futures market to engage in tax avoidance transactions. We believe that our position regarding the current Federal income tax treatment of RFC options further reduces the potential for tax avoidance transactions.

As you are aware, certain representatives of the securities industry have submitted proposals suggesting that exchange-traded options offered by the securities exchanges, such as options on stock, debt, currency and indexes (referred to hereafter as "exchange-traded securities options") and RFC options be taxed in a similar manner, i.e., under the 60/40 rule, in order to create a so-called "level playing field." We should stress that certain RFC options currently being traded on the commodity exchanges, such as options on gold and sugar futures, and those which are expected to be traded on the commodity exchanges, such as options on metals futures (silver), on energy futures (heating oil), and on agricultural futures (corn, soybean, wheat, pork billies, cocoa, cattle, etc.) do not in fact compete with the exchange-traded securities options. Aside from the fact that the competition issue is nonexistent with respect to these options, we should emphasize that these proposals would create a different tax regime for the exchange-traded securities options, i.e. the 60/40 rule, and for the property which is the subject of such options, i.e. applicable capital gains rules. Consequently, there would be a dramatic increase in the potential for tax straddling and tax abuse opportunities. These would arise because there would be a significant number of new straddle positions created such as positions consisting of exchange-traded securities options and non-exchange traded options or exchange-traded securities options and the underlying stock or other property. In addition, due to the large number of "dealers" in stocks and the ease with which so-called "market-makers" in stock options can claim "dealer" status for their option transactions and for the property to which the option relates, additional opportunities arise for such persons to treat their loss transaction as giving rise to ordinary losses while at the same time identify their gain transactions as giving rise to long-term capital gains. Congress would have to focus very carefully on formulating rules to prevent this increase in tax shelter activity before it could seriously consider these proposals.

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[4] Section 1256(a)(3).

[5] Section 1256(c).

[6] Section 1256(a)(1).

[7] Section 1256(b).

[8] Section 1256(a)(1).

III. DISCUSSION OF COMEX'S POSITION

In enacting the 1981 Tax Act, Congress recognized the role of the commodity futures markets to the economy. Thus, as stated in the General Explanation:[9] The Congress believed that commodity futures markets play an important role in the economy. These markets provide a valuable means for farmers to reduce their risks in the production of crops and for bulk customers to hedge their risks of price shifts. There has been an explosive growth in the futures market over the past decade, and there is good evidence that such growth will continue. Because of the importance of the commodities markets, particularly in the agricultural and commercial sectors, the Congress considered it critical that the efficiency of these markets be preserved and the liquidity of these markets maintained.

Under the 1981 Tax Act, a completely new regime of taxation was provided for RFCs. In general, all RFCs must be reported on an annual basis under a mark-to-market rule which corresponds to the daily cash settlement, mark-to-market system employed by commodity futures exchanges in the United States for determining margin requirements. Under such rule all RFCs must be marked-to-market at year end. Each RFC held by a taxpayer is treated as if it were sold for fair market value on the last business day of the year and any gain or loss is taken into account for the taxable year.[10] In addition, gain or loss which is required to be recognized on the termination of such futures contracts by offsetting, by taking or making delivery, or otherwise, must also be marked-to-market at such time.[11] In recognition of the fact that this mark-to-market rule in many cases would prevent a taxpayer from establishing a long-term capital gain holding period, all gains and losses on RFCs are treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss, the 60/40 rule.[12] Since the maximum tax rate on individuals is now 50 percent, the maximum effective tax rate on an individual's income from RFCs is 32 percent (60 percent long-term gain × 20 percent rate, or 12 percent, plus 40 percent short-term gain × 50 percent rate, or 20 percent).

In addition, the 1981 Tax Act provided special rules for the taxation of straddles composed of at least one position in an RFC and one or more positions in interests in property which are not RFCs. The effect of these rules is to treat offsetting positions of a straddle as a single economic unit. Losses on such a straddle transaction can only be claimed when an overall loss occurs in the transaction.[13] In addition, conversion of ordinary income to long-term gain was restricted by the requirement that interest and carrying charges in straddle transactions be capitalized,[14] and a special short sale rule prevents taxpayers from converting short-term gain to long-term gain and from converting long-term loss to short-term loss in a straddle transaction.

Congress felt the enactment of the 1981 Tax Act would end the use of futures transactions for tax avoidance purposes which allegedly threatened to disrupt the commodity markets, would establish an accurate method of determining a taxpayer's futures income and would ease tax administration for both the Government and taxpayers.[15]

Comex recognizes the aims of the 1981 Tax Act in this regard and emphasizes that its position with respect to the taxation of RFC options is totally consistent with these objectives. Any other rules that may be imposed would create the possibility of tax avoidance and tax straddling techniques and would create absurd results which are not in accordance with the aims of the 1981 Tax Act and not in accordance with the economic realities of transactions in the futures markets.

On October 4, 1982 trading began in options on the Comex futures contract in gold. Since their introduction 13 months ago, such RFC options have more than doubled their average daily trading volume to 3,000 option contracts per day and open interest in the contract has steadily climbed and now exceeds 32,000 option contracts. Consequently, the Federal income tax treatment of these RFC options is of utmost importance.

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[9] The General Explanation of the 1981 Tax Act, prepared by the Staff of the Joint Committee on Taxation, December 31, 1981 (cited hereafter as "General Explanation"), p. 283.

[10] Section 1256(a)(1).

[11] Section 1256(c).

[12] Section 1256(a)(3).

[13] Section 263(g).

[14] Section 263(g).

[15] General Explanation, p. 295.

Our legal position regarding the Federal income tax consequences of RFC options can be summarized as follows. First, a short RFC option qualifies as a "regulated futures contract" which is defined in Section 1256(b) as a contract: (1) with respect to which the amount required to be deposited and the amount which may be withdrawn depends upon a system of marking to market; and (2) which is traded on or subject to the rules of a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission * * *.

A short RFC option clearly falls within this definition. Such an RFC option is a contract with respect to which the amount required to be deposited and the amount which may be withdrawn depends upon a system of marking-to-market. The statutory requirement is met by virtue of the Comex and the Comex Clearing Association, Inc. rules governing the deposit or withdrawal of original and variation margin applicable to short RFC options. There is precisely the same sort of day-to-day marking-to-market of short RFC options as there is in the case of RFCs traded on the Comex. Finally, the option is traded on a market which is designated as a contract market by the CFTC.

Moreover, there is no conflict between the statutory provisions of Section 1256 and the provisions of Sections 1234 and 1234A. A short RFC option is both an option governed by Sections 1234 and 1234A and also an RFC. Section 1234(b) provides only that gain or loss from any closing transaction with respect to, and gain from the lapse of, an option shall be treated as gain or loss on the sale or exchange of a capital asset held not more than one year. The rules of Section 1256 are applicable to capital assets held for not more than one year as well as capital assets held for more than one year. Such rules simply provide for the 60/40 rule, irrespective of the holding period of such contract. Moreover, Section 1234A which is also applicable to a short RFC option merely provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property or of an RFC shall be treated as gain or loss from the sale of a capital asset.

With respect to a long RFC option, while such long RFC option does not meet the statutory requirements of Section 1256(b) because it does not entail the deposit or withdrawal of amounts dependent upon a system of marking-to-market, it nevertheless is taxed under the 60/40 rule by application of Section 1234.

Under Section 1234(a), the "character" of gain or loss attributable to the lapse, or sale or exchange of an option to buy or sell property, is of the same "character" as the "character" of the gain or loss on the sale or exchange of the underlying property in the hands of the holder of the option. Section 1256(a)(3) directs that any gain or loss with respect to an RFC, such as a Comex futures contract in gold, "be treated" as being made up of specified components of long-term and short-term capital gain or loss. These statutory provisions, read together, require that gain or loss to the holder on the sale, exchange, or lapse of a long RFC option, be treated as coming under Section 1256(a)(3).

Further, the legislative policy reflected in the enactment of Section 1234(a) requires such a result. Section 1234(a) is derived from the original Section 1234 first enacted in 1954. Its legislative history shows that this section was designed to prevent taxpayers from executing option transactions for tax benefits. Prior to the 1954 Internal Revenue Code, taxpayers were able to recognize capital gains and losses on the sale or exchange of the option itself, even though the sale or exchange of the underlying property may have produced ordinary income.

Accordingly, taxpayers would plan their transactions to recognize capital gains and losses on the sale or exchange of the option itself, when the underlying property increased in value, and to recognize ordinary loss by exercising the option and disposing of the property when the property decreased in value. To avoid this result, the Congress enacted Section 1234, which was intended to make the tax treatment in the case of sales and lapses of an option match the nature of the tax treatment of the underlying asset.

If gain and loss on a long RFC option is not brought under Section 1256(a)(3), but is taxed instead under the general applicable capital gains rules, a holder of an appreciated long RFC option held for less than a year could exercise the option, enter into an RFC and immediately close out the RFC at a gain. Such gain would be taxed under the 60/40 rule. On the other hand, if an RFC option held less than a year decreased in value, the holder would close out the option at a 100 percent short-term loss, instead of exercising the option and creating a loss covered by the 60/40 rule. The legislative policy in enacting Section 1234 was designed to prevent this type of election against the revenues.

We cannot overemphasize the point that if the RFC option is not taxed under the same 60/40 rule as the underlying RFC which is the subject of the RFC option, it would create the possibility of tax abuse activities on the commodity futures exchanges. Any possibility of encouraging attempts by taxpayers to engage in tax sheltering activity on the commodity exchanges by creating opportunities for tax straddles is clearly inconsistent with the policy of the 1981 Tax Act and would have a harmful effect on the commodity markets.

Moreover, a different tax regime for the RFC options and RFCs would produce absurd results which are not in accord with economic realities. For example, assume a taxpayer buys an RFC, e.g., a Comex futures contract in gold, at a price of $400. The market then rises to $420 and the taxpayer, in order to retain the potential for further market appreciation and to protect most of his profit in the RFC purchases a put option with a striking price of $420 at a premium of $8. The market then falls to $380 and the taxpayer closes out both positions just prior to the expiration of the put option. The taxpayer has realized a net gain $12 consisting of a $20 loss on the RFC and a $32 gain on the put. Assuming the taxpayer is taxed in the highest tax bracket, applying the 60/40 rule to such gain he would be required to pay a tax of $3.84 or 32 percent of $12. However, if the gain on the put option is not taxed under the 60/40 rule but rather under the applicable capital gains rules, the taxpayer would incur a tax of $9.60 calculated as follows:

	Loss		
	Total gain	Long-term gain	Short-term gain
RFC	($20.00)	($12.00)	($8)
Put	$32.00		$32
Total	$12.00	($12.00)	$24
Rate (percent)		20	50
Total tax	$9.60	($2.40)	$12

A tax of $9.60 on an economic gain of $12.00, or 80 percent is clearly ludicrous.

As a further example of unjustified results, assume a taxpayer buys an RFC, e.g., a Comex futures contract in gold, at a price of $420. In order to limit his risk if the market goes down, he purchases a put option having a $420 striking price, at a premium of $8. The market then drops to $380 and the taxpayer closes out both positions just prior to expiration of the put. The taxpayer has realized an $8.00 economic loss consisting of a $40 loss on the RFC and a $32 gain on the put. Again, assuming the taxpayer is in the highest tax bracket, applying the 60/40 rule to such loss, the taxpayer would have a tax benefit of $2.56, or 32 percent of the loss. However, if the gain on the put is not taxed under the 60/40 rule but rather under the applicable capital gains rules, the taxpayer would incur a tax cost of $3.20 calculated as follows:

	Loss		
	Total gain	Long-term gain	Short-term gain
RFC	($40.00)	($24.00)	($16)
Put	$32.00		$32
Total	$8.00	($24.00)	$16
Rate (percent)		20	50
Total tax	$3.20	($4.80)	$8

Clearly, to incur a tax of $3.20 on an $8.00 economic loss is absurd.

These examples are only two of many which could be constructed to show that the application of the capital gain and loss rules to RFC options would produce results not in accordance with the economic realities of a transaction.

It has been suggested in order to prevent the mismatching possibilities that would exist if the RFC options are not taxed under the 60/40 rule that a tax be imposed on the holder of a long RFC option on exercise of his option. We believe this approach is totally without precedent. Under general principles of taxation, the exercise of an option, whether it be on stock or on real estate, has always been regarded as the acquisition of the underlying property and not a realization event requiring recognition of income. On exercise of a long RFC option, the holder is in the same position he would have been if he entered into an RFC at the time of the option transaction, except that he has incurred a premium cost for the option. This premium cost allows a holder to benefit from favorable price movements while limiting downside risk. Moreover, the holder of a put options and the writer of a call option under the general rules of taxation recognize gain or loss measured by the difference between the sales proceeds (adjusted for the option premium) and the basis of the property delivered on exercise. There is no basis for recognizing or segregating gain or loss attributable to the value of the option on exercise. For example, assume a taxpayer has held a stock for a number of years with a zero basis. At a time when the price of the stock is $200, the taxpayer purchases a put option at a striking price of $200 and pays a premium of $5. If the price of the shares decreases to $100 and the put option is exercised by the taxpayer, he will realize a $95 gain all of which is taxed as a long-term capital gain. The tax law does not treat him as realizing a $100 long-term capital gain and a $95 short-term capital gain.

Aside from the fact that this approach is without precedent in the history of the income tax law, we should stress that a tax on exercise of an RFC option would have a devastating impact on the trading of options on gold futures contracts on the Comex. A large number of traders in Comex gold options actually exercise their options rather than closing them out by offset. We recently reviewed the total number of exercises for our June 500 put and June 420 call. The June 500 put option was initially out-of-the-money and then became a deep-in-the-money option. As such, it is representative of those options in which one would expect heavy exercises. Total exercises were 50 percent of the total volume and 81 percent of the volume after the option went in-the-money. Total exercises were 79 percent of the maximum level of open interest.

The June 420 call option was always an in-the-money option, but never a deep-in-the-money option. As such, it is representative of those options in which one would expect light exercises. Total exercises were 10 percent of total volume and 57 percent of the maximum open interest. As can be clearly seen, there is a high level of exercise by holders of our RFC options. The imposition of tax on exercise of those options would create a significant risk as to the viability of the options on Comex futures contracts in gold thereby denying hedgers and investors a limited risk way to participate in the gold futures market.

IV. SECURITIES INDUSTRY PROPOSALS

Certain representatives of the securities industry have submitted proposals suggesting that exchange-traded securities options and RFC options be taxed in a similar manner, i.e. under the 60/40 rule, in order to create a so-called "level playing field". Congress should be aware that certain RFC options currently being traded on the commodity exchanges, such as options on gold and sugar futures, and those which are expected to be traded on the commodity exchanges, such as options on metals futures (silver), energy futures (heating oil) and agricultural futures (corn, soybean, wheat, pork bellies, cocoa, cattle, etc.) do not in any way compete with the exchange-traded securities options. Even though the issue of competitive fairness does not exist with respect to these RFC options we should emphasize that there are numerous aspects of these proposals which would have to be changed or amended to avoid creating a heavily tilted playing field.

Under these proposals, a different tax regime would be created for the exchange-traded securities options, i.e. the 60/40 rule, and for the property which is the subject of such options, i.e. applicable capital gains rules. This would dramatically increase the potential for tax straddling opportunities because there would be a significant number of new straddle positions created as a result of these proposals such as positions consisting of exchange-traded securities options and non exchange-traded securities options or exchange-traded securities options and the underlying stock or other property.

Furthermore, due to the large number of "dealers" in stocks and the ease in which so-called "market-makers" in stock options can claim "dealer" status for their option transactions and for the property to which the option relates, further opportunities exist for such persons to treat their loss positions as giving rise to ordinary losses and their gain positions as giving rise to long-term capital gains. Undoubtedly the Congress could not allow such situations to exist.

Accordingly, before Congress even considers the merits of such proposals, it should focus on formulating rules to prevent the potential for tax shelter activities. These rules would have to deal with the identification problems concerning which positions constitute "offsetting positions" for purposes of the loss deferral rules, with questions relating to the availability of the "hedging exemption" for dealers in stocks, and with the problems surrounding dealers in stock and so-called "market-makers" in stock options who have the ability to claim dealer status enabling them to generate both ordinary loss and long-term capital gain treatment.

V. CONCLUSION

In concluding, Mr. Chairman, we believe our position regarding the Federal income taxation of RFC options in general, and our options on Comex futures contracts in gold in particular, is mandated under current law and is in full accord with the Congressional policy as expressed in the enactment of the 1981 Tax Act. Any change in the law which would provide a different tax regime for RFC options and the RFCs which are the subject of such options would encourage attempts by taxpayers to engage in tax shelter activities which would cause disruption of the commodity markets and would produce tax results which are not in accord with economic realities.

Mr. ANTHONY. Thank you, Mr. Cole.

Mr. Schapiro.

STATEMENT OF DONALD SCHAPIRO, COUNSEL, COFFEE, SUGAR & COCOA EXCHANGE, INC., ACCOMPANIED BY JAMES J. BOWE, SENIOR VICE PRESIDENT

Mr. SCHAPIRO. Mr. Chairman, Mr. Duncan, my name is Donald Schapiro and I am a member of the law firm of Barrett, Smith, Schapiro, Simon & Armstrong in New York City. We are counsel to the Coffee, Sugar & Cocoa Exchange, and with me here on my left is James J. Bowe, the senior vice president of the Exchange.

We greatly appreciate the opportunity to appear before this committee and ask that my prepared statement be included in the record.

Mr. ANTHONY. Without objection, your complete statement will be accepted for the record.

Mr. SCHAPIRO. The Coffee, Sugar & Cocoa Exchange, which is located in New York City, has been designated by the Commodities Futures Trading Commission as a contract market for trading futures contracts in coffee, sugar, cocoa, and for trading options on sugar futures contracts.

We heard the testimony of Secretary Chapoton at this hearing and had an opportunity to review his full statement which was made available to us for the first time this morning. We have little to add to the Treasury's discussion and analysis of commodity options. Our exchange respectfully urges this committee to adopt the approach as to commodity options supported by the Treasury and adopted by the Senate Finance Committee on Monday.

This would tax commodity options in the same manner as futures contracts—that is, under the mark-to-market 60–40 rule. We believe such an approach is logical and makes for a better and simpler tax law.

Secretary Chapoton and other witnesses referred to issues of fairness raised when commodity options are taxed under the mark-to-market 60–40 rule and competitive products are not. In the case of commodities for which futures and options are traded in the Coffee, Sugar, & Cocoa Exchange, there are no competitive items being traded in the United States.

The same is true for other agricultural commodities such as grains, which will probably be the subject of options trading on futures exchanges starting next year. Thus, there are no drawbacks at all to gaining the advantages of simplicity and fairness in taxing these agricultural commodity options under the 60-40 mark-to-market rules. Thank you.

[The prepared statement and memorandums follow:]

STATEMENT OF DONALD SCHAPIRO, COUNSEL, COFFEE, SUGAR & COCOA EXCHANGE, INC.

Good morning Mr. Chairman. My name is Donald Schapiro. I am a member of the law firm of Barrett Smith Schapiro Simon & Armstrong in New York City. We are Counsel to the Coffee, Sugar & Cocoa Exchange. With me today is Mr. James J. Bowe, a Senior Vice President of the Exchange. We greatly appreciate the opportunity to appear before this Committee today.

The Exchange, which is located in New York City, has been designated by the Commodity Futures Trading Commission (the "CFTC") as a contract market for trading futures contracts on coffee, sugar and cocoa, and for trading options on sugar futures contracts. It may also seek designation for trading options on cocoa futures contracts in the immediate future.

The Exchange respectfully urges this Committee to tax futures options in the same manner as futures contracts. We believe that such an approach is consistent with existing law and represents sound tax policy, particularly in the case of commodities such as are now the subject of futures and options trading on the Coffee, Sugar & Cocoa Exchange.

At present, the basic rules for the federal taxation of futures contracts are that in non-hedging (i.e., speculative) transactions, gains and losses are taxed 60 percent as long-term and 40 percent as short-term capital gains and losses, irrespective of the period of time such futures are held. At year end, all open positions on futures contracts are marked to the market (i.e., treated as if the positions were liquidated at the year-end closing prices), and any gains or losses are treated as having been realized, so that they are taxed even though the positions remain open. This mark-to-market rule reflects the fact that gains and losses on futures positions are settled daily in cash, so that holders of futures contracts at year end have in effect realized their gains and losses to that date, even though their positions have not been closed out. Thus, holders of profitable futures positions have received the cash with which to pay their taxes.

The tax rules for futures contracts have been clearly spelled out in the Internal Revenue Code. While the tax rules for futures options have not been as explicitly set forth, as we understand present law, gains and losses in non-hedging transactions in futures options should be treated as 60 percent long-term and 40 percent short-term capital gain or loss, irrespective of the actual period of time such options are held. Grantors of futures options should be subject to the mark-to-market rule under which gain or loss is recognized as of year end, because the grantor positions are subject to daily settlement in manner similar to futures positions. However, as the Code is now drafted, holders of futures options are not subject to the year-end mark-to-market rule because existing CFTC regulations in effect preclude daily settlement for the holders' positions. Rather, for holders, profits may only be obtained by selling or exercising the options.

Various parties have made suggestions that futures options be treated like securities options, so that all gains and losses would be treated as short-term capital gains and losses. We respectfully urge this Committee not to accept these proposals, but rather to tax futures options in exactly the same way that the underlying futures contracts are taxed—that is, under the 60/40, mark-to-market rule. This would be accomplished by redefining futures options as regulated futures contracts ("RFCs") under Internal Revenue Code section 1256(b). Such a course of action would entail changing one aspect of present law, in that the holders of futures options would be taxed on unrealized gains and losses even though there is no daily cash settlement on their positions. However, we recognize that this would be necessary to preserve the symmetry of the tax treatment of futures and options. Furthermore, the CFTC has under consideration proposals under which daily settlements for holders of futures options could be implemented in the future.

Treating futures options as RFCs would make for a simpler and better overall tax law without any apparent revenue loss.

Futures options are part of a zero sum system under which gains and losses necessarily cancel each other out. The Exchange has no reason to believe that applying a rule under which both gains and losses would be subject to treatment as 60 percent long-term and 40 percent short-term would produce any revenue loss as such.

As far as making the tax law simpler and better, the Exchange points out, first, that if futures options are treated as RFC's, there will be no need to apply complex rules to defer losses on tax straddles involving futures options and futures contracts, since the mark-to-market rule will apply, so that all offsetting gains will automatically be recognized. Of course, the current law contains rules which prevent claiming of straddle losses even where the mark-to-market rule is not applied, but it is generally recognized that a mark-to-market system which avoids reference to the loss deferral rules is far simpler and better for both the taxpayer and the Treasury.

Second, if futures options are treated as RFCs, there will be no mixed straddle problems created where futures options are traded with the futures contracts to which they relate.

The mixed straddle problem can be illustrated as follows: suppose that a taxpayer has a position consisting of an RFC offset by a non-RFC; assume further that there is a $1,000 gain on the RFC leg and a $1,000 loss on the non-RFC leg. Absent any "mixed straddle" rules, the taxpayer would wind up with a $600 long-term capital gain and a $600 short-term capital loss. If the taxpayer had other short-term gains, he would pay a tax of $120 (20 percent of $600) on the long-term gain, and save taxes of $300 (50 percent of $600 short-term gain) on the short-term loss. This would produce the anomalous result of a net tax savings of $180 without any economic gain or loss.

On the other hand, assume the market moved in the opposite direction, so that there was a $1,000 gain on the non-RFC position in the straddle, and a $1,000 loss on the RFC position. There would be a net of $600 of long-term loss, and $600 of short-term gain. If the taxpayer had other long-term gains, the straddle would produce the equally anomalous result of a net tax cost of $180 (consisting of a $300 tax cost on the short-term gain and $120 of tax savings on the long-term gain), again without any economic gain or loss.

The current tax law gives the Treasury Department authority to promulgate regulations under Internal Revenue Code section 1092(b)(2) to avoid or ameliorate the results illustrated above in the case of "mixed straddles." In order to give effect to this regulatory authority, complex rules involving recordkeeping of a detailed sort will probably have to be adopted.

If futures options on such commodities as sugar and coca are not treated as RFCs, there will be a whole new area of mixed straddles opened arising from trading in futures contracts together with these futures options. While there are currently mixed straddle issues raised in other futures areas where the futures contract can be traded against the physical item (for example, Treasury futures against Treasury obligations), the mixed straddle problem does not exist in the case of commodities such as sugar and cocoa, where there is no public market for the physical item available to speculators. As a practical matter, the only persons having access to the physical markets in these agricultural products are hedgers (i.e., commercial producers, dealers and users) whose gains and losses are all treated as ordinary income and losses. The same is true of other agricultural commodities, such as grains, which will probably be the subject of options trading starting next year. It makes for a better and simpler tax law if futures options on these commodities are taxed as RFCs.

That concludes our prepared remarks. Mr. Bowe and I would now be pleased to answer any questions you may have.

MEMORANDUM RE APPLICATION OF WASH SALE RULES AND SECTION 1092(a)

(By Donald Schapiro)

This memorandum describes a possible approach to developing regulations under Section 1092(a) and the wash sale provisions. The steps in the approach are described below.

Step 1. Isolate year-end unrealized apppreciation in "personal property" held by the taxpayer.

Step 2. With respect to each position in which there is unrealized gain, determine whether the position was a replacement for a substantially similar position closed out at a loss.

Step 3. If the answer to Step 2 is "yes", determine whether there was an oddsetting position open at the time the loss was taken; and if there was an offsetting position open at the time the loss was taken (that is to say, if the loss was taken in a straddle position), determine the amount of the loss. This loss is to be disallowed and deferred to the extent of the unrealized gain on the position being examined.

Step 4. If, after going through the prior steps, loss equal to unrealized gain is not deferred either because the position being examined was not a replacement for one closed at a loss while an offsetting position was open, or because the loss was less than the amount of unrealized gain, determine whether there were one or more offsetting positions closed at a loss at any time during the period the position being examined was open. If any such loss or losses can be identified, then defer such losses to the extent of any remaining unrealized gain in the position being examined which has not absorbed a prior loss deferral.

Application of rules such as those described above would involve determining what positions are to be related for purposes of the wash sale rules, and how long an interval of time between closing of one position and opening of another will uncouple the two positions for the purposes of wash sale rules. In other words, what is the analogue of the words "substantially identical" and the 30 day time period in Section 1091?

Section 1092(a) is somewhat easier to apply on the basis of the rule stated above because a search can be made for losses to be disallowed on positions which can be deemed offsetting during the entire life of the position with unrealized gain open at year-end.

MEMORANDUM RE PROPOSED MIXED STRADDLE RULE

(By Donald Schapiro)

The following is suggested as a "mixed straddle rule" for purposes of persons trading in large numbers of transactions in items which are RFCs and items which are not. The rule would be as follows:

1. Taxpayers would be permitted on an annual basis to elect to establish a mixed straddle account. This account would record all transactions the taxpayer wished to designate as mixed straddles. The account would show separately gains and losses in RFCs and gains and losses in non-RFCs (physicals). At the end of each year, the physicals on hand in the account would be marked-to-market with the gain or loss being recognized.

2. All items in the account would be capital gain or loss items. Items would have to be designated for the account as soon as they were entered into, although there would be no requirement that items will be matcheds as straddles when they are entered into the account.

3. At the end of each year, a calculation will be made of the net long-term gain or loss and net short-term gain or loss using normal 60/40 rules and treating gains and losses on physicals as being short-term.

4. Any net short-term loss would be converted to 60 percent long-term loss and 40 percent short-term loss. If there were a net long-term capital gain and no short-term capital gain, then that long-term capital gain would be converted 40 percent to short-term capital gain. If there were a net long-term capital gain and a net short-term capital gain, then the long-term capital gain would be converted to short-term capital gain to the extent, if any necessary, to make the aggregate capital gain (including long- and short-term) 40 percent short-term. (N.B. There would be no recharacterization of long-term loss or short-term gain). If there were a short-term loss and a long-term loss, then the short-term loss would be converted to long-term loss only to the extent necessary to convert the aggregate loss into 60 percent long-term.

5. In the event there were any remaining short-term loss or long-term gain as a result of the calculations made above, transactions not identified by the taxpayer in the account would be subject to being brought into the account if they were part of straddle transactions in which one leg was in the account and one leg was not.

DISCUSSION

1. Under the suggested rule, it would never be possible to have losses come out of the account in an amount which were not at least 60 percent long-term.

2. It would not be possible to have gains coming out of the account unless they were at least 40 percent short-term.

3. The deferral problem would be taken care of by the mark-to-market. The mark-to-market at year end is necessary to cause recognition of non-RFC, that is short-term transactions, where the taxpayer who has the right to recognize the transac-

tions by realizing on them finds it to his advantage not to do so. This could occur, for example, if a taxpayer wished to defer the taking of a loss on the physical which would act to offset some 60/40 long-term gain which appeared on the RFC side of the ledger. Similarly, if a taxpayer had long-term and short-term gain net, he might prefer to postpone taking in short-term gain if all such amounts would be taxable as short-term gain, hoping that in the following year the mix of transactions would be better.

4. It is necessary to provide the Internal Revenue Service with the right to require additional transactions to come into the account so that a taxpayer cannot, for example, keep the account largely with RFC transactions in which there is a gain taking offsetting physical transactions outside the account hoping to obtain short-term loss on these transactions.

Mixed straddle transactions which are not in the account would be subject to a rule under which all short-term loss which was offset by 60/40 gain would be recharacterized as 60/40 loss on a transaction by transaction basis. There would be no recharacterization of short-term gain into 60/40 gain. The consequence of this rule would be very harsh for taxpayers having a variety of transactions. This would encourage taxpayers who do a multitude of transactions to enter them in the mixed straddle account or, in the alternative, to make the identified mixed straddle election.

Mr. ANTHONY. Mr. Schapiro, I am going to ask you if you would do the committee a favor. I would like to ask you a series of questions not in your role as representing your client, but simply in your role as a tax expert in this particular field. I understand that you had a great deal of, I would use the word "influence," but at least a lot of help in trying to examine the problem in 1981.

What do you see as the major problems outstanding from the 1981 legislation, the straddle legislation?

Mr. SCHAPIRO. Well, I would like to make it clear that I am talking purely as an individual and not on behalf of any organization or person. I am expressing my own views as a student of the tax law. There are really a number of issues still outstanding. I might say that I welcome the question by this committee, because I think a lot of the open issues need your help. I do not think that the Treasury Department by itself can necessarily deal with them all or at least deal with them all in a way which everyone will accept as final.

Now, having said that, let me review with you some of the things that I think need dealing with. As to the topic of stock and stock options that we talked about this morning, the concepts of offsetting positions which were developed for commodities have to be thought through if the statutory rules are going to be applied to stock.

For example, would there be a balanced position created in options, if one of the positions were in General Electric and the other in Westinghouse, or if one were in Ford and the other were in General Motors. I do not know what the answers are, but I do know that thought has to be given to that problem when we get there.

There are very important problems on the conversion, or opportunities of conversion, from short-term gain to long-term gain which are open because we do not yet have a set of mixed straddle rules out. The mixed straddle problem which we have heard about is essentially a mechanism whereby people can convert short-term gain to long-term gain by going into transactions in which one balanced position is a regulated futures contract and the other balanced position is not. If a taxpayer goes at this long enough and hard enough, he can ultimately stop the game when he has a win on the long-term capital gain side and a loss on the short-term capital loss side. And if that loss can be offset against other short-term capital gains, there is a conversion.

Now, there are rules available for Treasury regulations to be promulgated in the 1981 act. These regulations have not been put out. I must say that people are now advertising publicly what is euphemistically called tax planning in these kinds of straddles. They are saying conversion opportunities are available. I do not think such opportunities exist. I do not think the Treasury Department thinks they exist but the rules are not yet clear. Perhaps some help from the Congress is needed here.

There is an issue open in the stock area for sales against the box. A taxpayer can go long and short the same stock without any economic risk, and close out the loss position in the current year, and bring the gain position over to the following year. While the Treasury Department and the Revenue Service would no doubt say that these transactions lack economic substance, sometimes they may and sometimes they may not, particularly if you are dealing with stock of different corporations. That problem has to be addressed in terms of the entire area of dealing with actual or perceived tax abuse.

There is a very real problem also in the area of winners and losers when there is an opportunity for ordinary income and capital gain in the same type of transaction. When you read the promotional material on tax shelters, the theory of the promotion is that it is the investment objective to have capital gain and ordinary loss. I do not know how it is possible to do that without a little help from looking behind. The whole area of identifying which transactions are ordinary and which transactions are capital is absolutely critical. Thought has to be given to how that can be done.

I do not know whether there is enough law on the books to do that. Perhaps something has to be done with some sort of penalty provisions for people who assist in late identification of transactions as between ordinary and capital.

There is a problem also of rolling ordinary income from one year to the next by virtue of taking current losses and deferring offsetting gains by people who allege that they are marketmakers or dealers in various items. They take their losses and push their gains forward. This is a problem that congressional staff were aware of in 1981. They knew it existed. It was not dealt with it then. I think it should be dealt with now, this problem of taking ordinary losses, and moving gains off to the following years.

There is, unfortunately, an administrative problem about which I do not think anybody has a really good idea as yet. The fact of the matter is that our entire tax adjudicatory system is tied up with old straddle cases. Essentially, everything has sort of ground to a halt in the decision of prior cases. I do not know what can be done about that. Maybe nothing. But at least some thought ought to be given to that, because cases are piling up and nothing is happening. That really is not the way a tax system ought to operate.

I would like to say something finally about the covered call problem discussed today. I personally have a lot of trouble with the exemption being urged from the straddle rules. I do not really see why one should be able to take a tax loss when he does not have an economic loss, even though the transaction is not tax motivated. There may be reasons. I am just not sure I understand them. Perhaps the losses on certain covered calls should be allowed against gains on these types of transactions.

There is a lot going for the theory of a 60–40 mark to market in stock options as a matter of concept. There are policy reasons which the Treasury has stated in its submission which may go to the contrary, and I do not comment on those. The Treasury Department's views on that seem to me, in reading their statement, to be twofold. One, is the applying the 60–40 mark to market rule to stock options is complex, and there are many technical problems. I agree with that but I think the problems could probably be solved. Two, there is a policy problem. I say nothing about it.

I would also say that I do not think that if changes in the tax rules as to straddles are limited to the approach suggested by the Treasury Department as to commodity futures contracts and stock options we will be left with a satisfactory tax system. I think there will continue to be problems. I think there will continue to be people selling tax shelter. I think the problems of the type I mentioned above need to be addressed. Both the Congress and the Treasury Department must address these issues with help from the industry.

I do not think that we can put a Band-Aid on the existing law and expect perceived tax abuse to stop. I do not believe that just putting stock options under section 1092 is going to be the answer to the basic fundamental problem of whether people are paying taxes fairly. We must ask whether things are working the way they should or are people selling tax abuse? I think more has to be done than the Treasury Department has proposed. It is really a question just of an allocation of time and effort. Is there enough time and effort on the part of people to go into this thing and to deal with these hard and complex problems?

Mr. Anthony. Since you mentioned 1092, I did have a further question I wanted to ask you, but let me preface it with another question before I get into it. If stock options were placed on a mark to market system and stock were not, what problems do you think we would experience?

Mr. Schapiro. The problem you basically have there is the problem of people who are dealing in offsetting positions in options and stock. A lot of thought has been given to this by the gentleman who testified before, and I must say a lot of excellent thought. I have had the occasion to meet and talk with them about it in some detail. I think a rule is needed to prevent conversion of short-term gain to long-term gain, which is an effective biting rule. I think it can be done. I think probably as part of that rule you have to give taxpayers the ability to combine transactions and elect a mark to market for stock which is part of tax straddles.

In other words, if a taxpayer says, look, I have a mixed tax straddle account and I am putting in stock and I am putting in options, I think it is critical as part of that election that you have the stock in that account mark to market at yearend.

If taxpayers do not follow that approach, and do not identify things in the mixed straddle account with a bunch of prophylactic rules which will go with it, I think the Treasury Department ought to adopt regulations which will really be very, very, very tough. By being tough, I mean this: Where you are in a mixed straddle and your physical side, that is, your non-RFC side, has a gain in it, and your RFC side has a loss, all the gain is taxed as short-term gain. However, where it goes the other way, where the RFC side has the gain and the non-RFC side has the loss, I think you convert the loss to 60 to 40, for which there is authority under the statute. You say to everybody else dealing in mixed straddles who is not coming into this sheltered world of identification and mark to market: If you folks want to play with this and you win, you will get nothing; and if you lose, you will come out essentially with a 50-percent tax rate. You will have your losses treated as long-term capital losses and your gains treated essentially as short-term capital gains.

Mr. ANTHONY. Well, maybe I ought to ask you a more basic question. Does mark to market work, and does the loss deferral under section 1092 work?

Mr. SCHAPIRO. Mark to market works very, very well. The loss deferral rule under section 1092 does work. The loss deferral rule under section 1092 needs some regulations to be promulgated under it. Essentially it was drafted with the thought that at the end of the year, the administrative mechanism would be as follows: Ask the taxpayer, please tell me what are your unrealized gains. There is authority in the statute to require the return to disclose unrealized gains. The regulations have not come out yet. I think they should.

Now, when the revenue agents have the list of unrealized gains, they can concentrate on what is basically the fruit or potential fruit of the tax straddle, that is, losses recognized and gains not. Then it is possible for the auditing agent to just pick out of the whole bundle of a taxpayer's transactions during a year those transactions that could offset the items with unrealized gains.

I think the system for loss deferral works very well, provided the regulations are promulgated. To the extent some help is needed in the statutory language, this committee and the other committees of Congress should go forward with it. Obviously, the mark to market rule for the futures contracts works very easily, and that deals with most of the contracts in futures markets. And indeed, if commodities futures options are, as the Treasury Department recommends and the Senate Finance Committee acted, put under the 60-to-40 rule, that will eliminate, as to these options, all loss deferral problems simply and all conversion problems simply.

Elimination of loss deferral and conversions is easy, where the whole system is 60 to 40 mark to market. With a system that is not 60 to 40 mark to market, you have to do something more. You have to identify what the unrealized gain is, and go out and find offsetting transactions but it can be done. Section 1092 will work provided regulations are promulgated which say we are going to go out and match up these positions and defer the losses which offset these gains.

Mr. ANTHONY. Thank you very much on behalf of the committee and the chairman of the committee for sharing with us some of your knowledge as a tax expert in these areas. Please submit for the record any additional thoughts or suggestions you may have for us.

Mr. SCHAPIRO. I would be delighted to supply whatever answers I can. I am really honored at the opportunity to assist in the development of some improvements in our tax law, which we all need so badly.

Mr. ANTHONY. Well, this is a very complex and fast-moving issue. It is a complicated area for the average investor to understand because it is very sophisticated. Your testimony has been beneficial and helpful to us. Mr. Cole and Mr. Bowe, thank you for appearing also.

Mr. Duncan, do you have any questions or comments?

Mr. DUNCAN. No questions. Thank you.

Mr. ANTHONY. Thank you very much.

The next panel will be the American Electronics Association, Arthur Lasch, Jr., member, board of directors, and chairman, steering committee on capital formation, and president and chief executive officer, Machine Intelligence Corp, and CAE Technology, Inc.; the National Venture Capital Association, Allen Neece, legislative counsel; Wayne Hummer & Co., Mr. George E. Barnes, senior partner; and Stockholders of America, Inc., represented by Margaret Cox Sullivan, president.

Welcome to the committee. We will take your testimony in the order in which your names were called out. That is, Mr. Lasch, Mr. Neece, Mr. Barnes, and Ms. Sullivan. We are happy to accept your complete prepared testimony for the record, and you are permitted at this time to either read it, summarize it, or proceed as you wish.

STATEMENT OF C. ARTHUR LASCH, JR., MEMBER, BOARD OF DIRECTORS, AND CHAIRMAN, STEERING COMMITTEE ON CAPITAL FORMATION, AMERICAN ELECTRONICS ASSOCIATION, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, CAE TECHNOLOGY, INC.

Mr. LASCH. In the interest of speeding things up, Mr. Chairman, I will try to just summarize this, Mr. Chairman.

I am appearing this morning on behalf of the American Electronics Association, and I am a board member of the association, which represents some 2,300 high technology companies nationwide, and has employees of some 2 million, and represents about $140 billion in sales.

Mr. ANTHONY. Let me interrupt you. We are having problems with the microphone and are having a hard time hearing your testimony. So if you do not mind, let us restart.

Mr. LASCH. All right. I guess I cannot say now that this is in the interest of speeding things up.

Mr. ANTHONY. As advanced as we are electronically, sometimes we have difficulties.

Mr. LASCH. I am appearing on behalf of the American Electronic Association, and I am a director of that organization. The organization represents some 2,300 companies nationwide. Those companies have approximately 2 million employees. And they account for about 140 billion dollars' worth of sales worldwide.

I do not want to belabor you with repeating much of the things that you have heard from other people relative to the need to maintain the distinction between long-term capital gains and ordinary income. I think much of the prior testimony has gone over that. But I am here basically to reinforce our position that it is of vital importance to our industry to have this type of tax preference.

The characteristics of high technology industries are simply that they are not benefited by accelerated depreciation and this type of tax relief. They need a very yeasty capital market in order to finance their growth. The companies grow very rapidly, and in doing that, they not only generate very disproportionate employment growth rates, but also the need for capital.

I can speak from my own experience, having started some five companies in the last 25 years, and of those five companies, four of them I financed through venture routes, and one of them I financed myself, when there was no venture available. That was during the period 1969 through 1977. So I can speak with firsthand experience as to what the reduction of the capital gains taxes has meant.

The other thing that we want to stress is that the maintenance of this kind of tax preference is very important because of the differences that we find in capital formation in our trading partners. During the period of 1969 through 1977, we essentially lost our position in the dynamic RAM industry, RAM memories, simply because our semiconductor industry could not generate enough capital to increase productivity to meet the market demands. So, we had to go and make partnerships with the Japanese and, of course, we have really lived to regret that.

I think that is probably a good summary of what we have to say.

[The prepared statement follows:]

STATEMENT OF C. ARTHUR LASCH, JR., MEMBER, BOARD OF DIRECTORS, AND CHAIRMAN, STEERING COMMITTEE ON CAPITAL FORMATION, AMERICAN ELECTRONICS ASSOCIATION

SUMMARY

It was no accident that the first industry to call for reducing capital gains taxes in 1978 was the U.S. electronics industry.

The characteristics of this industry (high salaries, fast job growth, high R&D budgets, short product lives, serve price pressure, and aggressive, well-capitalized foreign competition) conspire together to generate an intense and continuing need for new infusions of risk capital investment.

Investors in high techology companies typically receive no dividends. They seek capital gains. The risks of investing in these companies are already high, and therefore the 1969 and 1976 increases in capital gains taxes severely damaged the risk/reward ratio needed to attract investors.

The result was to severely damage the ability of U.S. high technology companies to start-up and grow during that period.

It also led directly to the Japanese invasion of the U.S. semiconductor market, when the U.S. semiconductor companies could not finance adequate production capacity to meet the demand for the new 16k RAM chip.

The 1978 and 1981 capital gains tax reductions have dramatically improved the situation. But these gains must not be taken for granted or lost.

STATEMENT

Mr. Chairman, members of this distinguished committee, my name is Art Lasch. Until recently I have been the Chairman, President and Chief Executive Officer of Machine Intelligence Corporation, a 100 employee company which designs, manufactures and sells intelligent robotic systems to the international market. I am now President and Chief Executive Officer of CAE Technology Inc., a new company involved in high speed visual inspection of security printing.

I am appearing before you this morning on behalf of the American Electronics Association on whose Board of Directors I serve. I also serve as Chairman of AEA's Capital Formation Steering Committee.

The American Electronics Association now represents over 2,300 member companies nationwide. The Association encompasses all segments of the electronics industry including manufacturers and suppliers of computers and peripherals, semiconductors and other components, telecommunications equipment, defense systems and products, instruments, software, research, and office systems. The AEA membership includes companies of all sizes from "start-ups" to the largest companies in the industry. But 72 percent are small companies employing fewer than 200 employees. Together our companies account for $140 billion in sales—63 percent of the worldwide sales of the U.S. based electronics industry.

ORIGINS OF THE 1978 CAPITAL GAINS TAX REDUCTION

Mr. Chairman, we sincerely appreciate the opportunity to appear before you at this important hearing. As you know AEA has been active on capital formation issues in general, and capital gains taxation in particular since 1978 when we were the first national organization to mount a serious effort to reduce the maximum capital gains tax level from 49 percent back down to 25 percent. You may recall that our testimony before the Committee that March was presented by another young company president who has since become a Member of Congress himself, the Honorable Ed Zschau, from my home area, the 12th District of California—better known as Silicon Valley.

So much has changed in the public and Congressional attitudes toward capital gains incentives since that time that it is already difficult to recall how radical the idea of reducing capital gains taxes was in the climate of 1978.

In those days, this tax preference was firmly lodged on the list of abuses crying out for "reform". The previous decade had seen a series of increases in the capital gains rate with very little organized outcry. The previous year the Carter Administration had publicly discussed proposing the total abolition of capital gains preferences and had only recently relented to request instead still another incremental increase in this tax on long term investment.

Against this tide, and with no visible support from the rest of the business community (which at the time was attempting to coalesce around the goal of ending double taxation of dividends) Ed Zschau and AEA proposed a substantial reduction in capital gains taxes. It seemed quixotic to many. One national columnist at the time began a piece on the Ways and Means hearings with the words: "In any history of the Tax Act of 1978, Ed Zschau probably wouldn't rate even a footnote".[1]

But that prediction turned out to be spectacularly wrong for two reasons. First, though none of us knew it at the time, the nation was ready to re-think the importance of risk capital investment in the economy. Economists, businessmen, and taxpayers of most ideological stripes were ready to call a halt to the anti-investor reform tide of the 60's and early 70's. Courageous Congressmen like the late William Steiger, Congressman Jim Jones, Bill Frenzel and Ed Jenkins were ready to introduce and press for enactment of a bill to once again encourage risk capital investment. What they lacked was a rationale and a constituency.

That rational—a new set of factors to consider in deciding the importance of the capital gains preference—was the second reason the reduction movement took off. Ed Zschau's testimony documented for the first time the central role that these incentives play in the viability and international competitiveness of the U.S. high technology industries. That new constituency and those new arguments triggered a movement toward capital gains reduction in other sectors of the economy, and the idea began to look less radical.

In fact, by the end of April 1978, an absolute majority of the Ways and Means Committee had either cosponsored or committed to support the Steiger Amendment. And less than two months after Zschau's "voice in wilderness" testimony, Senator Clifford Hansen of Wyoming introduced the Senate version of the capital gains reduction bill with 61 co-sponsors—and the movement could no longer be stopped.

Mr. Chairman, my purpose in reviewing this history is to remind you of the past and continued importance of capital gains preferences to the high technology industries in the U.S. It was no accident that these companies were the first to speak out on this subject. Though their arguments have now been heeded, and the treatment of capital gains substantially improved over that in 1978, we still hear occasional suggestions that an incentive for long-term investment may not be all that important.

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[1] Robert J. Samuelson, "Making Life Difficult for Congress" National Journal, March 18, 1978.

The purpose of the remainder of my statement is to explain once again the characteristics of the high technology industries that make this tax preference so important to them and to the nation.

THE IMPORTANCE OF HIGH TECHNOLOGY TO THE U.S. ECONOMY

First, it is fair to point out the growing importance of these companies to the U.S. economy as a whole. A recent Commerce Department study concluded:

High technology industries are vital to the U.S. economy. Their growth rate has been twice that of total industrial output, and they contribute the bulk of technological advances to all sectors of the economy.

National security depends upon the technology-intensive industries both for sophisticated items essential to modern weapons superiority, and for a strong and flexible industrial capability for future contingencies.

The United States will have to depend heavily on its areas of greatest strength—principally advanced technology—to meet increased competition in world markets. The technological challenge confronting the United States can benefit all competitors and nations through increased efficiency and growth.[2]

CHARACTERISTICS OF HIGH TECHNOLOGY INDUSTRIES

These important companies and their markets have several distinctive attributes that set them apart from other businesses:

1. They tend to be labor-intensive rather than capital intensive in their production processes. They employ a higher percentage of highly-paid scientists, engineers and technicans than other manufacturing sectors, which leaves them vulnerable to labor shortages in these skill areas.

2. They tend to be more science-based than other industries, with a much higher emphasis on R&D. During the 1970's these companies generated more than 60 percent of the total private R&D in the U.S., although they represented only 13 percent of the value of manufacturing product shipment.[3]

3. These companies grow rapidly, and in doing so they generate disproportionate employment growth rates. The Commerce study reports that nine of the ten fastest growing U.S. industries in recent years have been in high technology.[4] Another recent study by the Joint Economic Committee reported the high technology industries accounted for 75 percent of the growth in jobs in the entire manufacturing sector from 1955-1979.[5]

4. These companies are unusual both for their own productivity, and the productivity of their products. During the 1970s, average labor productivity of the industries in the high technology group grew six times faster than that of total U.S. business,[6] while the products they manufactured are used to generate substantial productivity improvements in all other sectors of the economy.

5. Another high tech distinctive is its tremendously dynamic marketplace with extremely short product generations—sometimes as short as one or two years. The product changes in these industries are generally not cosmetic or stylistic, but functional improvements that must be brought to market with no increase in price because of the intense price competition that pervades the industry.

6. Finally, these companies are different by almost invariably being international in scope. The R&D cost to develop new generations of products is sufficiently high that each generation of products must be sold to the broadest possible marketplace to generate sufficient revenues to continue funding future product development. Thus, U.S. technology companies must sell their products competitively in foreign markets.

If, for whatever reasons, U.S. companies become non-competitive in foreign markets, foreign competitors will develop the broader earnings base to finance larger R&D activities to develop the next generation of superior products for sale in the

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[2] An Assessment of U.S. Competitiveness in High Technology Industries, U.S. Department of Commerce, International Trade Administration, February, 1983, pg. iii.

[3] Ibid., pg. 4.

[4] Ibid., pg. 3.

[5] Location of High Technology Firms and Regional Economic Development, a staff study prepared for the Subcommittee on Monetary and Fiscal Policy of the Joint Economic Committee, Congress of the United States; June 1, 1982, pg. 6.

[6] Commerce Department, ibid., pg. 3.

U.S. Thus, in order to survive and grow even in the United States, U.S. high technology electronic companies must be competitive in worldwide markets.

The tough competition our companies face in international markets is amplified by the fact that many of our strongest cimpetitors (Japan and Germany for instance) levy no tax on capital gains, thereby substantially reducing their companys' cost of capital.

CONTINUED DEPENDENCE ON RISK CAPITAL INVESTMENT

Nearly all of these high technology distinctives (high salaries, fast job growth, high R&D budgets, short product lives, severe price pressure, and aggressive, well capitalized foreign competition) conspire together to generate an intense and continuing need for new infusions of risk capital investment in these companies.

For example, the 1978 AEA Capital Formation Survey, upon which Ed Zschau's testimony was based, documented that though young high tech companies generate new jobs at near record rates, an average $32,720 in company assets was required for each new job created.[7] Even though these companies retain almost all their earnings and pay almost no dividends to their investors, there is no way they can finance their growth through retained earnings alone. They need constant injections of new equity capital. The young companies in the AEA survey required an average of $14,000 in risk capital to create each of the 131,000 new jobs the surveyed companies had generated since 1955.[8]

Attracting investors

Since investors in high tech companies can expect no dividend income, their only motivation is capital gains. Any change in the tax on those gains is felt immediately by the companies trying to finance their growth. At the same time the risks of investing in a young technology company are extremely high. These risks are particularly severe in the electronics industries where the possibility of R&D failures and rapid technological obsolescence are added to the many challenges that other small companies face. In order to justify investing in such high risk ventures, the investor requires a high potential rate of return. Such high returns don't come from dividends. They are only possible from capital gains.

What the Tax Reform Act of 1969 did

The Tax Reform Act of 1969 affected several provisions in the capital gains area. That Act restricted the use of the alternative tax rate to $50,000 of capital gains, with any excess gains being subject to the regular rates. At that time, one-half the gain was deductible and the maximum regular marginal rate was 70 percent resulting in an increase of the effective maximum captial gains rate from 25 percent to 35 percent. Additionally, the Act also imposed a 10 percent minimum tax on "tax preferences" exceeding $30,000, which included the untaxed portion of net capital gains. Thus, in some instances, the minimum tax further increased the effective rate on capital gains by 5 percent.

The combined effect of the alternative rate and minimum tax change was an increase in the maximum captial gains rate from 25 percent to 40 percent (a 60 percent increase). Further, the Act cut the available offset for capital losses by 50 percent by providing that only one-half of long-term capital losses could be used to offset ordinary income. The stated purposes underlying these changes were a redistribution of the tax burden in a more equitable manner, and a limitation on the tax advantages accruing to corporations and high-bracket taxpayers. But the actual effect of these changes was much different than anticipated.

EFFECTS OF INCREASED CAPITAL GAINS TAXES

One of the reasons Ed Zschau's 1978 testimony struck the responsive chord it did was because it documented clearly, for the first time, the serious damage the 1969 increases in capital gains taxes had done to the ability of young high technology companies to start up and grow. That tax increase severely damaged the risk/reward opportunities for potential high tech investors. The executives responsible for raising these funds certainly knew it had become much more difficult to finance their companies, but the AEA survey quantified it.

The chart below, stated in current dollars, showed that in the first years of their existence, the surveyed companies founded during 1971-75 were able to raise only one-half as much equity capital on the average as those firms founded during 1966–70. By 1970, the 135 firms founded in the 1966–70 period had raised an average of $1,039,000 in risk capital, while by 1975 the 77 companies founded during 1971–75 had raised only $522,000 per firm. That was even less than the capital the companies founded during 1961–65 raised in 1961–65.

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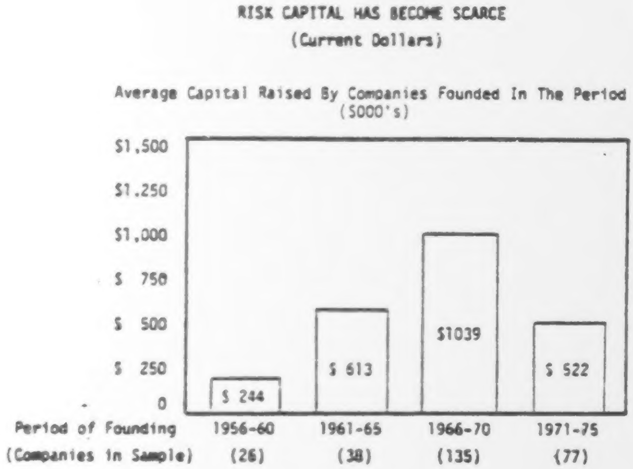
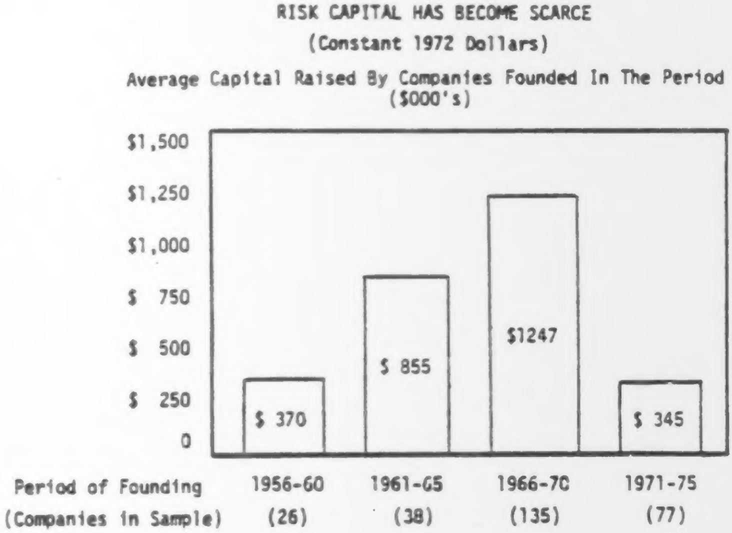
[7] Statement of Dr. Edwin V. W. Zschau, on behalf of the American Electronics Association before the House Committee on Ways & Means, March 7, 1978; pg. 5.

[8] Ibid.



But when inflation is taken into account, the true magnitude of the capital scarcity problem is revealed. The chart below, stated in constant 1972 dollars, showed the firms founded in 1971–75 were able to raise on the average less than 30 percent as much capital as firms founded during 1966–70 raised during the 1966–70 period. In fact, in terms of purchasing power, the new companies formed since 1971 had been able to raise less capital per firm in their early years than firms founded at any time in the past 20 years.



HOW THE JAPANESE PENETRATED THE U.S. SEMICONDUCTOR MARKET

Mr. Chairman, the perspective of a decade allows us to recognize a number of important results of the anti-investment policies of the early 1970's that were only suspected as recently as 1978.

The most dramatic example is probably the invasion of Japanese semiconductor companies into the U.S. semiconductor market. In 1973 the demand for 16K random access memory (RAM) chips exploded far beyond the ability of the U.S. semiconductor industry to supply. This forced the U.S. manufacturers of products using 16K RAM's to initiate relationships with Japanese sources—many for the first time. Their products were good and their share of the market has expanded substantially since that time.

But the undercapacity of the U.S. industry was not a natural event. We firmly believe it was directly attributable to the drmatic decline in the availability of risk capital in the U.S. so clearly documented by the AEA Survey. And the cause of that drop in available capital was the 1969 increase in capital gains taxation. That change literally drove investors away from our companies.

Mr. Chairman, the reason we are here today reminding you of those past mistakes is to try to assure that they will not be repeated in the future. New technologies, with major new capital requirements are emerging every year in our industry. It is vital that our nation's investment policies never again hand major new markets to our foreign competitors.

RESULT OF THE 1978 AND 1981 REDUCTIONS IN CAPITAL GAINS TAXES

Mr. Chairman, a number of the witnesses at today's hearing are concentrating on documenting the spectacular results that lowering capital gains taxes have had on investment in the U.S. economy. I will only tell you that its impact on our industry has been dramatic and sustained. There has been a remarkable inflow of funds to venture capital firms and record setting disbursements to their portfolio companies. Additionally, a 1980 New York Stock Exchange study [9] reveals that between 1975 and 1980, the stockholder population rose by 4.6 million to 29.8 million (a 18.1 percent increase) reversing a decline in the prior five-year period. The report also shows that 22 percent of current stockholders are new investors, compared with 9 percent in 1975. Further, the NYSE found that after the tax cuts took effect, 130,000 new investors entered the stock market in an average month, compared with 86,000 in previous months. NYSE Chairman William M. Batten attributed much of this increased activity to the 1978 reduction in capital gains taxes.

The increased availability fo funds and demand for equity secutrities afforded many small companies a badly needed opportunity to raise new capital through offerings of common stock. New capital raised through initial public stock offerings of corporations climbed sharply in late 1978, and dramatic gains were reports in 1979 and 1980.[10]

CONCLUSION

Mr. Chairman I hope our testimony today has made clear the importance of capital gains incentives to the U.S. electronics industry and to the U.S. economy as a whole. We are encouraged by the understanding of this point which we now find in Congress. But we also recognize the importance of continuing to document the case for new generations of policy makers. Therefore, allow me to reiterate our appreciation for this opportunity to appear before you at this important hearing.

I would be happy to respond to any questions you may have.

Mr. ANTHONY. Thank you very much, Mr. Lasch.

Mr. Neece.

STATEMENT OF ALLEN NEECE, LEGISLATIVE COUNSEL, NATIONAL VENTURE CAPITAL ASSOCIATION

Mr. NEECE. Mr. Chairman, I am Allen Neece, appearing today on behalf of the National Venture Capital Association, a 149-member association whose collective assets range somewhere between $5 and $6 billion. We have not had an opportunity to appear before this committee since the 1978 and 1981 capital gain reductions. I am really here to say that both of those reductions were watershed events in the capital formation process in this country.

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[9] "Changing Patterns in the Public Ownership of U.S. Corporations," New York Stock Exchange (1980), As described in Capital Formation, Vol. 6, No. 1, American Council for Capital Formation (January 1981).

[10] 1975—$265 million; 1976—$234 million; 1977—$153 million; 1978—$250 million; 1979—$506 million; 1980—over $1 billion.

Source: Going Public, as reprinted in The 1978 Capital Gains Tax Reduction: Progress Report II, Oscar S. Pollock, Ingalls & Snyder (January 23, 1981). This report further notes that in 1978 and 1979 the new capital derived from venture capital firm disbursements and initial stock offerings was almost $2.5 billion ahead of the comparable 1976-1977 total.

And to really give you some figures as evidence of that conclusion, in the last 6 years, $8.5 billion has flowed into the venture capital industry, and approximately $9 to $10 billion has been invested in new, innovative, young, growing firms.

Those figures eclipse anything that has been experienced since World War II, and to give you a stark contrast to that, in 1975, a grand total of only $10 million, not billion, but only $10 million was invested in the venture capital industry in 1 year alone.

In this year alone, we anticipate that approximately $3.6 billion will be invested in new venture capital pools and SBIC's, or small business investment companies. The long and the short of this, Mr. Chairman, is that those two reductions have really lowered or put more in line the risk-reward ratio, which is something we are fond of talking about in the venture business. Those risks were inordinately high in comparison to the rewards that were available back in the days when the capital gains tax rate was hovering at the 49-percent level.

With those two reductions, we have seen a massive infusion of funds, which I have already spoken to, but in addition to that we have seen an outpouring of interest on the part of would-be entrepreneurs, and in fact those entrepreneurs have given up very secure jobs to start and form new companies. That is what this dynamic process is all about, and those are the kinds of concerns that we fund.

Previous witnesses today have spoken to the additional revenue, and hopefully net gain realized by the Federal Government as a result of those two reductions.

I would like to point out one figure that has not been mentioned today. That is, the Council of Economic Advisers released data in April of this year indicating that in a 2-year period following the 1978 reductions, the Federal Government realized a net gain in the capital gains area of 111 percent, or a little in excess of $30 billion. GAO released a study in August 1982 doing an in-depth analysis and study of the venture capital industry, and I would like also to dwell on those figures for just a minute.

They examined 72 companies in which venture capital firms had invested a total of $209 million during the decade of the 1970's. Those 72 companies by 1980 had gone public, and what did they find? Of the $209 million invested, and that is the cumulative total that had been invested by the benchmark year of 1979, $6 billion in cumulative sales had been realized by those 72 firms. They were also experiencing an average annual increase in sales of 33 percent, and 130,000 new jobs had been created at a total cost of only $209 million, and that was all in private sector dollars, by the way. That was a dynamic, positive feedback to the Federal Government. They realized, and this is on a per annum basis, $100 million a year in new corporate income taxes, and $350 million a year in net new personal income taxes by the employees. Further, they were also experiencing $900 million a year in new export sales. All of that was as a result of only a $209 million investment.

We call that an incubator model, of the thousands of new companies that have been financed in the last 3 years, we would suggest that in the late 1980's and in the 1990's that experience will be increased by many fold.

In sum, Mr. Chairman, we would caution this committee and the Congress in general to avoid the temptation as you cast your net about in the future to raise additional revenues not to tinker with that capital gains tax rate by increasing the rates. If anything, you might target additional rate decreases to assist venture capital and small business concerns in the future.

Finally, Mr. Chairman, we are supporting the reduction from the 12-month to the 6-month holding period.

[The prepared statement follows:]

Statement of Allen Neece, Legislative Counsel, National Venture Capital Association

EXECUTIVE SUMMARY

The data obtained from the venture capital industry by Venture Economics, a subsidiary of the Capital Publishing Corporation, clearly shows a direct correlation between the reduction of the rate of tax on capital gains and the growing availability of funds to the venture capital industry for investment in new emerging companies.

The capital gains rate reduction of 1978 and 1981 and the subsequent increase in the differential between the tax on capital gains and the tax on personal service income dramatically encouraged investment funds for the development of new small businesses.

The National Venture Capital Association recommends that since the August 1982 General Accounting Office Study shows that venture investment has an extremely positive impact on the economy that additional capital gains reforms be instituted as follows: (a) reduce the maximum corporate capital gains rate to 20 percent; (b) increase the exclusion to 80 percent for gains realized on original issue securities held for at least five years, and (c) authorize a deferred payment of capital gains taxes if the proceeds of a liquidated capital asset are "rolled over" into a small business concern.

STATEMENT

Mr. Chairman and members of this distinguished committee, my name is Allen Neece and I am legislative counsel of the National Venture Capital Association which has 152 members nationwide. The association was organized to foster a broader understanding of the importance of venture capital to the vitality of the United States economy.

CAPITAL GAINS TAX

Beginning in 1969, Congress gradually increased the long-term capital gains tax rate so that by 1977 the maximum rate stood at just over 49 percent. In 1978, that trend was reversed as the rate was reduced to 28 percent. A further reduction to 20 percent was enacted in 1981. During the three years preceding the initial 1978 reduction, venture capital firms only invested $1.8 billion in new business ventures. In the three years following 1977, $5.4 billion was invested by the venture industry in the innovative, independent business sector which represents a 300 percent increase over the earlier period. This increased investment activity was all made possible by a corresponding infusion of new capital into professionally managed venture capital firms.

VENTURE CAPITAL INDUSTRY—ESTIMATED FUNDINGS AND DISBURSEMENTS

[Dollars in millions]

Year	New private capital committed to venture capital firms	Estimated disbursements to portfolio companies	Public underwritings of companies with a net worth of $5 million or less	
			Number	Amount
1982 estimate	$1,700-$1.800	([1])	112	$617
1981	1,300	$1,400	306	1,760
1980	900	1,000	135	822
1979	319	1,000	46	183
1978	570	550	21	129
Capital gains tax decrease:				
1977	39	400	22	75
1976	50	300	29	145
1975	10	250	4	16
1974	57	350	9	16
1973	62	425	409	896
1971	95	410	248	551
1970	97	350	198	375
Capital gains tax increase:				
1969	171	450	698	1,367

[1] Up somewhat.

After the 1978 legislative action, there was a commensurate increase in initial public offers which is an important ingredient in creating a favorable climate for venture investing. The chart below illustrates the total dollar volume for all companies going public for the first time regardless of net worth of the corporation.

New capital raised through initial public stock offerings—millions of dollars

1975	265	1979	506
1976	234	1980	1,397
1977	153	1981	3,215
1978	249	1982	1,445

It is thus obvious why both government and private sector analysts credit the two rate reductions with increased individual investment and risk-taking, stimulating entrepreneurial activity, accelerating the mobility of capital, and fostering new productivity enhancing investment.

And best of all, these achievements were realized at no net cost to the Treasury. In fact, total capital gains tax revenue increased from $9.3 billion in 1978 to $11.2 billion in 1979, and $11.9 billion in 1980. The government realized additional "windfall profits" in 1982 as the "unlocking" or selling of seasoned mature investments continued to occur.

The benefit of a capital gains cut was recently underscored by the Chairman of the Council of Economic Advisory (CEA) when he stated the "amount of capital gains reported on tax returns increased dramatically in the years after the tax rate on capital gains was reduced. He went on to say the CEA analysis "shows that reported net long-term gains less net long-term losses rose from $30.3 billion in 1977 to $63.8 billion in 1979, up 111 percent."

But, there is still a problem! Even after a three-fold increase in the amount of new capital being made available to young, growing small businesses, recent congressional hearings revealed that there is an estimated annual equity capital shortfall of between $6 and $7 billion.

To increase further risk taking and thereby divert more dollars to start-ups and young, high-growth, job producing concerns, three types of incentives should be enacted.

One: In 1981 and 1982 approximately 20 percent of all new capital committed to venture capital firms was corporate affiliated. That figure represents a sharp fall-off from the better than 30 percent contributed by corporations in the previous two year period between 1978 and 1980. One of the key reasons is that the Economic Recovery Tax Act in 1981 failed to lower the maximum long-term corporate capital gain tax rate from 28 percent to 20 percent as it did for individuals. The simple solution to this disparity is to place the corporate investor on par with the individual taxpayer and make the maximum applicable rate 20 percent for both.

Two: A distinction needs to be made between the commonly thought of long term investment of between six and twelve months and the very long term financing that is held for five years or longer. Such a distinction is needed for it would more accurately reflect the long term nature and recognize the higher level of risk associated with the typical venture investment. This illiquid, very long term capital commitment should be rewarded by increasing the exclusion to 80 percent for those gains realized on the sale of securities purchased directly from the corporation, not in the secondary market. The net effect is that the maximum capital gain rate would be reduced by 10 percent.

This proposal is meant to compliment pending legislation that would reduce the minimum capital gains holding period to six months. Such an interval would help maintain viable public markets which are crucial to those concerns that have received venture capital backing and are or already have "gone public."

Three: Still a further incentive should be considered. If the realized gains of a capital investment were reinvested in or "rolled over" into a small business concern within an 18 or 24 month period, the payment of the applicable capital gains taxes could be deferred until the taxpayer sold the small business securities and did not "rollover" the proceeds into still another small company.

An August 1982 GAO study on the venture capital industry provides ample evidence of the benefits that would be multiplied if these capital gains related provisions were enacted. GAO studies 1,332 emerging businesses financed between 1969 and 1977, a period where U.S. tax policies are described by GAO as having "damaging ripple effects on business creation and risk taking." The study concludes:

> The experiences of 1,332 companies that were started with venture backing during the 1970s demonstrate benefits to the nation's economy and productivity that are disproportionately large when compared with the amounts of capital invested. For example, with $209 million invested to create 72 of these firms, their combined sales in 1979 alone totalled $6 billion. Growth in annual sales averaged 33 percent a year and, in the process, these firms created an estimated 130,000 jobs, over $100 million in corporate tax revenues, $350 million in employee tax revenues, and $900 million in export sales.

If $209 million can produce this type of impressive and disproportionately beneficial results, imagine what would happen if between $10 and $20 billion a year were made available as a result of enactment of these three incentives.

I thank you for your attention and welcome any questions.

Mr. ANTHONY. Mr. Barnes.

STATEMENT OF GEORGE E. BARNES, SENIOR PARTNER, WAYNE HUMMER & CO.

Mr. BARNES. I am George Barnes. I am a member of the New York Stock Exchange and the New York Futures Exchange, although I cannot go along with any tax program that will give special capital gains treatment to any industry or exchange members. If we do this, we are going to fall flat on our face, and the sooner we recognize that, the better. I cannot emphasize that enough. I hope to have the answer today for the CBOE and other industries who may have a capital gains problem. And I would like to read my prepared statement.

As a student of Federal taxation for more than 60 years, I welcome the opportunity to file this statement. It is based on long experience in preparing tax returns for clients and others on a volunteer basis, responding to taxpayer correspondence with the IRS, counseling investors on the wisdom of taxing gains and losses, as a trust officer and/or a broker, and serving as a member of national and State tax study committees.

More recently, I submitted testimony and statements to the House and the Senate pointing out the problems incurred in attempting to withhold a 10-percent tax on dividends where a portion represented either capital gains and/or nontaxable payments. Extending over the years, I have observed at first hand a compulsion on the part of individuals to establish losses each year for tax saving purposes and a real reluctance to realize gains arising from the sale of property holdings, all to the detriment of Federal revenues and the impediment of capital formation.

Unfortunately, taxpayers do not often act in their best interests, basing sales of property solely on tax considerations. First, a bit of history on capital gains taxation that I have taken from the February 1946, issue of the New York Stock Exchange magazine. I discovered this in my files in the preparation of this statement. It follows:

> When the 1942 Revenue Act was passed, a capital gains section was hailed as a long step forward in encouraging capital investment. Long term holdings at that time were redefined, and instead of an 18-month holding period, the time limit was cut to six months. The 25-percent maximum rate was cited as an encouragement to risk taking, and to help production and provide jobs.
>
> Inasmuch as we have been on a war production basis most of the time since the Act was passed, we really have not had an opportunity to observe its workings. Realizing this, Congress is not likely to make any change in this section until it has an opportunity to see it working under normal peacetime conditions.
>
> A permanent solution would seem to lie in a better knowledge of human reactions to our present capital gains tax laws in times of booms as well as depressions. Perhaps a lower rate on capital transactions might produce more revenue, and that should be a governing factor in any rate change, to repeat, and as long as there is a capital gains tax, there will be a mental reservation against making tax sales.
>
> If the best results are to be obtained, common sense dictates that investors rely on investment judgment in decisions to hold or sell assets rather than fear of present tax rates or hopes for more repeal treatment.

In commenting on the foregoing statement which I made in 1946, the exchange emphasized that much stress has been laid upon a 25-percent tax on capital gains, whereas this flat tax applies only in certain cases. As I pointed out in a separate table, a copy of which I have here today, an effective 1946 rate on full long-term capital gains ranging from 9.5 percent in the first bracket and 25 percent on those with incomes of $18,000 after personal exemptions would result.

Is it not ironical that political considerations over the years had outweighed our capital formulation needs in vacillating holding periods together with rates on capital transactions? To raise the most revenue and at the same time provide incentive taxation instead of penalties, I raise the question: Is it time to eliminate a capital gains tax?

As you know, there are strong advocates to replace our income tax system with a flat tax, in the belief that it would solve and simplify our income tax code. I could never be one to agree to this change in principle on taxation and income for the reason that, one, it would not remain flat for very long, and two, higher personal exemptions made necessary in the interest of equitable treatment for those in the lower income brackets. It would result in halving the number of taxpayers on the present rolls.

A flat tax should never be considered, because it would create rate injustices and leave the tax burden on fewer people. On the other hand, such a flat tax is ideal for capital gains to replace present graduated rates ranging from 4.4 to 20 percent. A lot of people do not understand that.

Under our prior system of taxing capital gains, we have been condoning penalties instead of incentives to build jobs and stimulate our economic growth. As a result, we are finding that other industrial nations are making daily inroads on both our domestic and world markets. Long have other leading industrial nations recognized that a capital gains tax is self-defeating, and they were eliminated.

It is still not too late for us to do so, although it may not be able to be done in one step.

Furthermore, taxing of capital or principal is contrary to common law. It is not generally realized that capital gains do not represent income subject to distribution to beneficiaries of estates and trusts. Our firm is very familiar with this distinction between income and principal in serving as custodian for many years of family trusts and estates in practically all of the 50 States.

In many instances, we prepare the tax returns for fiduciaries and maintain their complete accounting records. Personally, I have served over the years as trustee or successor trustee of a number of trusts, so that I have become familiar with the need to maintain separate accounts for principal and income, and the disposition of what constitutes income to beneficiaries.

I have yet to recall a single instance where direct capital gains were distributed to a beneficiary. In fact, I have felt for some time that it would make it easier for the IRS, taxpayers, trustees, and accounting firms alike if separate tax returns were required on capital gain and loss transactions and pay any tax due. With the number of daily capital changes resulting from stock dividends, spinoffs, reorganizations, and reinvestment of dividends, it has become too great a task for either business firms, accountants, governments, or taxpayers to administer.

Administrative costs have risen to the point that the overall costs exceed the revenues. Therefore, the present system of penalties instead of incentives no longer has a place. I see no alternative or solution to the problem than to consider the simplified proposal which I submitted to your committee on May 24, 1977, which comprised a nongraduated single rate structure which, one, made no allowance for offsetting capital losses against ordinary income; two, accomplished broad simplification of form 1040 in not mixing capital gains with ordinary income; and three, produced a substantial increase in Treasury revenues with a flat rate of 12.5 percent without any exemptions.

This flat rate compares with 1983 graduated rates ranging from 4.4 percent to 20 percent in the top income bracket. Our 1977 proposal allowed for the proper carryover provisions against future capital gains. This flat tax structure is just as applicable today as it was then. If there is any holding period continued, it should be no longer than 3 months to accommodate commodity transactions and minimize wide market swings. Filing and payment of capital transactions could either be made on a separate return form 1040 or the tax could be added to the bottom line of form 1040. This change alone would result in major simplification of our tax system.

Now, if there is a distinction as between the long- and short-term gains, there should be a flat tax, not a graduated tax, as we have now. According to my current thinking after hearing the other gentlemen who have testified today, a flat tax of 25 percent on short-term gains, would solve the problem of the CBOE and any other groups that might be coming before you in the future. Maybe it will be the real estate people next, or maybe it will be the stockbroker if the volume gets too low, but we do not want people coming to us, to this committee or any other source and pleading for special treatment. It is going to end in the destruction of our tax system.

Neither will the lowering of the capital loss limitation against ordinary income from $3,000 to $1,000 meet our needs as compared to a single rate structure of 12.5 percent on long-term gains and 25 percent on short-term gains with no exceptions to any taxpayer whether or not there is any other tax obligations.

Consequently, the lowering of the capital loss allowance against other income serves little or no purpose, and what is the difference if they reduce it to $1,000? It means that they are taking it off over 3 years as opposed to 1 year, and I do not see anything accomplished by that sort of an arrangement.

It is my hope that I have been helpful in your deliberations.

I would like to depart from my text in regard to the matter of giving any thought to granting preference special rates, as for example, to the CBOE and the electronics industry or any other group from whom you have received pleadings today for further preference capital gain incentive rates. Further, in the event the capital gains holding period is not eliminated in one step, I would suggest you consider a flat long-term rate of 12.5 percent and a flat rate of 25 percent on short-term transactions.

Your attention is called to the fact that our short-term rate structure is 2½ times the long-term rate structure at the present time, and we simply cannot live with that, because it is too large a differential to be made to work. Our proposal calls for a flat rate of 12½ percent on long-term transactions, 25 percent on transactions that are completed within 3 months, resulting in a differential of only 12½ percent. This would alleviate all the problems that were brought to the attention of your committee today to grant further tax preferences and prevent tax class legislation in any form.

Money would roll in. There would be no deterrence. That is the kind of capital gains tax law we wish to see instituted in this country to provide capital incentives instead of penalties. Then there would be little or no reason not to take a gain, no matter what the amount of the gain may be.

Mr. ANTHONY. Does that conclude your remarks, Mr. Barnes?

Mr. BARNES. That concludes my remarks.

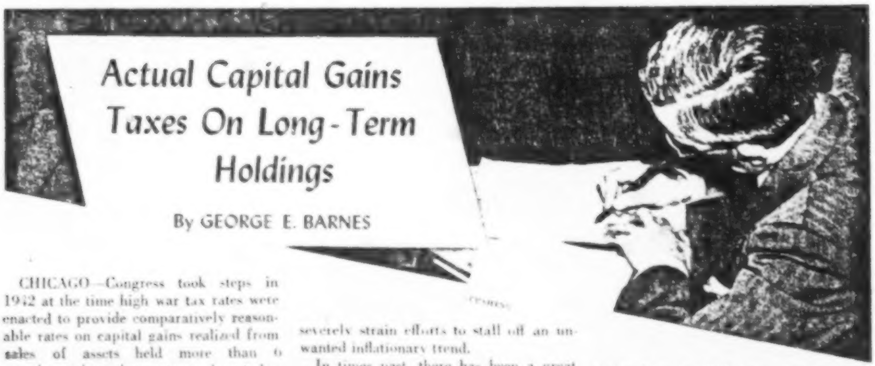
[Attachments to the prepared statement follow:]

The Exchange

A MAGAZINE OF THE FINANCIAL COMMUNITY

VOLUME VII, NUMBER 2 . . . . . . FEBRUARY, 1946

THE EXCHANGE is a monthly publication of the New York Stock Exchange. *Editorial Offices,* 11 Wall Street, New York 5, N. Y. Telephone HAnover 2-4200. Subscription price $1.00 a year



Actual Capital Gains Taxes On Long-Term Holdings

By GEORGE E. BARNES

CHICAGO—Congress took steps in 1942 at the time high war tax rates were enacted to provide comparatively reasonable rates on capital gains realized from sales of assets held more than 6 months, and yet the response given today by many investors is something like this:

"I cannot afford to sell and pay the tax."

Prices have been moving upward for a long time, to give many holders of securities in our American corporations an attractive appreciation if they chose to take it. Many of those who understand the operation of our tax laws on capital transactions have established some gains, or intend to do so, but it will be found that many investors today are reluctant to realize them because of a misconception of the actual tax liability on sales.

The idea that the tax on long-term property items (holdings of more than 6 months) amounts to a flat 25 per cent levy has achieved surprising acceptance.

Thus, we find decisions made daily on an *erroneous tax liability* rather than on values. It is believed that this misunderstanding has now reached the proportions of an important market factor, the results of which might attract official intervention. Fear of paying a "high" tax on present gains, many believe, might curtail the floating supply of stocks and severely strain efforts to stall off an unwanted inflationary trend.

In times past, there has been a great deal of discussion of "selling to establish losses for tax savings purposes." That was a popular device for years to reduce taxes on other income. Fortunately, by limiting the deduction for net losses from other income to $1,000 in any one year, Congress took steps when it revised the Capital Gains Law in 1942 to protect property holders against falling all over themselves to sell at the expense of further depressing values.

Under present market conditions, the chief concern seems to be, "why sell and pay a big tax?"

LONG-TERM CAPITAL GAIN RATE TABLE FOR INDIVIDUALS WITH OTHER INCOME

Effective 1946 Rates on Full Long-Term Gains of:

*Amount of Other Income	$1,000	$2,000	$3,000	$5,000	$10,000	$15,000
$1,000	9.50%	9.50%	9.82%	10.07%	11.02%	12.22%
2,000	10.45	10.45	10.45	10.83	11.97	13.11
3,000	10.45	10.45	11.08	11.59	12.73	14.00
4,000	12.35	12.35	12.35	12.73	13.87	15.01
5,000	12.35	12.35	12.98	13.49	14.63	15.93
6,000	14.25	14.25	14.25	14.62	15.77	17.01
7,000	14.25	14.25	14.88	15.39	16.53	17.96
8,000	16.15	16.15	16.15	16.53	17.77	19.00
10,000	18.05	18.05	18.05	18.53	19.83	20.96
12,000	20.43	20.43	20.43	20.81	21.85	22.80
14,000	22.33	22.33	22.33	22.61	23.47	24.32
16,000	23.73	23.75	23.75	24.14	24.89	25.00
18,000 and over	25.00	25.00	25.00	25.00	25.00	25.00

*After personal exemptions

What's Coming in Federal Taxation or What's Gone From Our Federal Tax System?

by george e. barnes
senior partner, wayne hummer & co., chicago

Remarks by George F. Barnes, senior partner, Wayne Hummer & Co., to the Research and Education Committee of the LaSalle Street Cashiers, Inc., Chicago.

It does not require a crystal ball to tell you what's coming in federal taxation unless the American people rise up and take more interest in what is taking place. It is that simple.

What's coming are yearly changes in our tax laws to upset and impede our economy. You cannot constantly change the fundamental tax laws of this country without causing economic disruption and uncertainties.

What's gone is confidence in our government with its legislation preferences in treating one taxpayer differently from another. For example:

The top ceiling rate today on **unearned** income is 70% compared with 50% for **earned** income. In the bottom bracket, the simplification act passed earlier this year, taxes a dependent minor $342 on $3,200 income from **bank** interest, while another dependent minor with salaried income of $3,200 goes tax free.

Taking first things first, it is important to know that a tax monster, greater in size, was created in the enactment of the 1976 Tax Reform Act with its burdens, complexities and inequities that carry over from generation to generation.

Therefore, the first job of this Congress is to reform the supposedly simplified 1976 Tax Reform Act which created the mess in which we find ourselves today and was the occasion for President Carter saying last year: "Our tax laws are a disgrace to the nation."

Also, I have been urging President Carter and his aides to repeal certain aspects of the 1976 Reform Act to reduce the size of this monstrosity that is so burdensome and tends to destroy capital incentives and lower employment.

It is encouraging to me to receive daily telephone calls and letters from those across the nation who have taken the time to examine the monster that the 1976 Revenue Act created. This monster came into being by the elimination of the "fresh start" in establishing property values at death, along with carryovers of cost values on gifts and bequests of property from generation to generation in the treatment of capital gains.

Sure, one can look in the paper to get stock and bond valuations but there are no published quotations for farms, family corporations, oil wells, and so forth which cannot be ignored. I could speak at length in regard to the bureaucracy and cost burdens this legislation passed in 1976 has created.

I am sorry to say that little attention is being given to forthcoming legislation by our own industry. Why? It is selfishly thought by some in our business that relief from double taxation is around the corner, the top bracket will be reduced from 70% to 50% and they would make a good swap for treating capital gains as ordinary income.

I sent a letter under date of August 22, 1977 to each officer and partner of every member brokerage firm in the United States, some 2,400 in number, to alert them to the present burdens on taxpayers as well as our industry. Also, I sent the same material to each member of Congress. **Believe it or not, the responses from Congress have out numbered 10 to 1 those from our industry.**

I find unless property was sold this past year, the average taxpayer is not familiar with the 1976 change in capital gains treatment. As an example, a lady came in this week to tender a block of shares of Miles Laboratories at 47. These shares were held in the family for many years and the idea of foreign interests buying the company did not appeal to her. In calculating her gain, there would have been only 60% left of the principal after taxes had the full tender been made. The full block of shares was not tendered to conserve her assets. We concluded that if Miles Laboratories dropped one-half in value on the balance of the shares not tendered, our client would not be any worse off.

There is quite a contrast in the treatment of capital gains in this country to that of the industrial nation of Japan which eliminated taxes on capital gains 23 years ago for the reason that it was interfering with capital formation. It will be of interest that the Japanese Consulate General of Chicago recently interviewed me for a good portion of a day on the effect of capital gains on our economy. Insofar as I am concerned, Japan will not have a capital gains tax for another 23 years.

Our present capital gains tax laws are not only impeding our economy but are producing nominal revenues when compared with what a lower rate could do to swell the Treasury revenues. In other words, we are pricing ourselves out of business with totally unrealistic penalty rates.

It is inconceivable that the Administration is thinking of raising the rates on capital gains at a time they should be lowered to encourage capital to supply jobs and meet needed government revenues. Capital gains taxes should be totally eliminated from our tax system but this cannot be accomplished in one step.

In the Congressional Record of July 20, 1977, I presented a five-point tax reform proposal to the House Ways and Means Committee. The proposal calls for:

- Simplification of the tax code.
- Taxation of earned and unearned income on the same basis.
- A gradual elimination of the double taxation on dividends.
- Increase capital investment by improving incentives and plugging loopholes.
- Replacement of the estate tax on capital gains with a uniform tax for all capital transfers.*

As to what is ahead, unless there is strong opposition, the Administration will likely consider again a withholding tax on dividends and interest. Senator Kennedy has already introduced a plan for such withholding at a rate of 20%. There is no reason for such withholdings since information returns are already filed with the Treasury Department on all such income except interest on coupon securities which is simple to correct and plug loopholes by merely requiring such reporting.

It is not understood by our own industry that withholding tax on interest would mean that every sale of a corporate or government bond would either involve a "due bill" or bonds would be traded flat, without interest. It would be difficult for even a computer to cope with this.

The Administration has already indicated its plan to reduce the double tax burden on corporate income. It is proposing a "Gross Up" dividend plan that has already received approval of many in our industry. Since such a proposal would make it possible for taxpayers in the lower brackets to substantially reduce their taxes or receive refunds through the overstating of their dividends, the door is left wide open for defrauding the Federal Government. Unless you do, I do not know of any way to put someone in jail for overstating their income.

My own proposal originally contained only four points and did not include any relief from double taxation for the reason that it would mean either a substantial increase in the tax on other forms of income or a larger federal deficit.

As an alternative, I sent the House Ways and Means Committee a proposal in May of this year to minimize taxes on corporate income which will work in all brackets and treat all classes of investors in an equitable manner. Furthermore, it can be **phased** in over a period of time and the Government would not lose important revenues.

There is no pride of authorship on my part in submitting my Five-Point Proposal. I am endeavoring to offer some alternatives which would serve our economic and Government budget needs. This is not the time to increase Federal deficits by offering temporary tax cuts. Such cuts would only add to our long term fiscal and economic ills.

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*For a further discussion of Barnes' tax proposal, refer to the October 1977 issue of the **Illinois Banker**, p. 14.

At 79, he still fights for tax reforms

People

By William Gruber

GEORGE E. BARNES, a securities broker since the days of the 1929 stock market crash, has been an advocate of reforms in the federal tax system throughout his career.

Although he now is 79 and a bit slower in his step, Barnes is still campaigning for changes in the tax laws. In fact, he intends to testify before a congressional committee next month.

He also is an inveterate letter-writer on his favorite subject. He says he has lost count of the letters he has sent to presidents, members of Congress, other investment industry officials, and newspapers.

"I'LL NEVER quit," said Barnes, who began helping individuals and businesses in the preparation of their tax returns in 1917, only five years after the graduated federal income tax was started.

Barnes chalks up as a "major victory for people trying to build an estate" the repeal last year of a planned new "carryover" tax on inherited property, which would have taken effect in 1980. The Treasury Department tried until mid-December to preserve the measure, he said.

He also worked closely with the late Rep. William A. Steiger [R., Wis.] in a successful bid to reduce the capital gains tax on investment profits in 1978.

Now he is campaigning for a gradual removal of the remaining capital gains tax, arguing that it would stimulate investments and needed capital formation in the United States.

"WE'VE GOT TO compete with other countries, which have more generous tax laws," Barnes said. "Otherwise, we'll go the route of Britain and become a second-rate nation."

Some of his other proposals might find fewer adherents in the investment world. For example, Barnes thinks tax shelters should be eliminated because they keep interest rates artificially high.

Barnes calls for "closing a loophole" involving coupon interest payments on bonds, contending that many bondholders fail to report such income.

"There's no way the government can check on it," he declared. "When you send in a coupon, it goes to the bank, which sends it to the paying agent. It stops right there."

FURTHER, HE OBJECTS to provisions giving preferential tax treatment to deferred income, saying they are unfair because such rules benefit only a few taxpayers.

He is unhappy with the dividend reinvestment plans offered by many corporations to stockholders for the same reason, insisting they "dilute" the value of shares held by people who don't use the plans. But he added that he would object less if the companies returned to a practice of offering additional shares to existing stockholders at a reduced price.

"There's been a tremendous change taking place in Washington," Barnes said. "The trend is toward thinking of ways to help and encourage capital formation, which is sorely needed in this country. I think we'll see great changes in tax concepts during the next few years."

HOWEVER, BARNES said the new attitude is appearing faster in Congress than in the executive branch. "The Treasury seems to think proposing tax changes is its prerogative," he said. "It isn't."

BARNES REMAINS a senior partner of Wayne Hummer & Co., a Chicago brokerage firm he cofounded in 1931 with Hummer, who now is 94 years old. He spends only "six months and one day" at his home in River Forest. On the other "five months and 30 days," he works full-time from a condominium in Ft. Lauderdale, Fla.

The veteran broker asserts that today's stock market conditions "are entirely different" from those which led to the Black Tuesday panic of Oct. 29, 1929, when he started in the business and "didn't change my clothes for two days."

HE BELIEVES that today's relative lack of interest in stocks by investors is temporary, however. "Sooner or later, people are going to realize that returns are high and price-earnings ratios never have been better. Then they'll have a field day."

George Barnes has been fathoming the mysteries of U.S. tax laws since 1917 and has been an advocate of tax reform throughout his career as a securities broker. Now 79 years old, Barnes says, "I'll never quit."

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SCHEDULE A ITEMIZED DEDUCTIONS
INTEREST EXPENSE

For the year ended: + ________

NAME AND ADDRESS AS SHOWN ON 1040 ________________ SS ________ SS ________
Spouse Yourrs

16 a. HOME MORTGAGE INTEREST PAID
TO ~~FINANCEAL~~ FINANCIAL INSTITUTIONS-

To whom paid	Complete Address	Date Paid	Amount Paid

16 b. HOME MORTGAGES PAID TO INDIVIDUALS
AND ON PERSONAL LOANS:-

To Whom Paid	Address	Payee I.D. S.S. No.	Date 1099 Filed		Amount Paid
17. CREDIT CARDS AND CHARGE ACCOUNTS:					
			NONE		
			"		
			"		
			"		
			"		
			"		
			"		
			"		
			"		
18. OTHER PAID-INCLUDING RELATIVES:					
+					

TOTAL INTEREST EXPENSE
(Enter on line ~~20~~ 19 Schedule A

NO DEDUCTION CAN BE TAKEN AS EXPENSE UNLESS COPIES OF

Page____

SCHEDULE B 1 DIVIDEND INCOME FOR YEAR ENDED ________, 19___
Of ____________________________________. S.S. No. ______________________________

Name of Corporation or nominee (If nominee, give Tax Identification No.	-1- Gross Am't. Received	-2- Qual. Reinv. Dividend	-3- Non. Tax. Distrib.	-4- Cap. Gain Distrib.	-5- Net Amount Taxable
Do not include dividends reported Schedule E, line 31					

TOTAL (Subtract 2, 3 & 4 from column (1) Enter amount Page 1 1040 Line 8b)

SCHEDULE "B" - INTEREST INCOME FOR YEAR ENDED ______, 19___.

Name(s) as shown on Form 1040 ____________________ S.S. Spouse __________ Yours __________

Name of Payer or Nominee Complete Address	- 1 - S.S. or Tax I.D. Number Payer	- 2 - Recipient →	- 3 - Gross Amount Received	- 4 - Acc'd. Int. Paid or Exclusions	- 5 - Net Amount Taxable
(1) List below interest received from Sellor-financed Mortgages and Personal Loans					
Enter on this line - sub-totals reverse side					
Sub-totals (1)					
(2) Other interest received from savings institutions, corporate and gov't. bonds, life trusts, annuities, etc. (Do not include interest from trust reported on Schedule E line E)					
Enter on this line - sub-totals reverse side					
Sub-totals (2)					
(3) List below Is interest received from tax-free State and Municipal obligations					
Enter on this line - sub-totals reverse side					
Sub-totals (3)					
(4) Interest received from Savers-Certificates -see Page 21					
Sub-totals (4)					
(5) Grand total of net taxable interest column (5). Enter page (1) 1040 (Add Sub-totals 1, 2, 4)					

↑

DO NOT EXTEND
for use of State tax bodies,
Federal Estate and Gift Tax
Audits

USE REVERSE SIDE FOR ADDITIONAL INTEREST INCLUDED ABOVE

Page ____

SCHEDULE B - SUPPLEMENTARY LIST OF
INTEREST INCOME (Continued)

Name(s) as shown on Form 1040 ____________________

For the year ended ____________________

Name of Payer or Nominee and complete address	(1) S.S. or Tax I.D. Number Payer	(2) S.S. or Tax I.D. Number Recipient	(3) Gross Amount Received	(4) Acc'd. Interest Paid or Exclusions	(5) Net Amount Taxable

(Enter subtotals - reverse side to determine net taxable Interest Income)

Mr. ANTHONY. Thank you very much.

Ms. Sullivan.

STATEMENT OF MARGARET COX SULLIVAN, PRESIDENT, STOCKHOLDERS OF AMERICA, INC.

Ms. SULLIVAN. Thank you, and gentleman, I am glad you stayed, and I appreciate the opportunity to appear before you.

My name is Margaret Cox Sullivan, and I am president of Stockholders of America, and we represent the interests of over 32 million stockholders, stockholders owning stock in the publicly held American corporations, and today I am also speaking for the 95,000 individual stockholders in the National Association of Investment Clubs. It is a segment of the 32 million.

We are grateful that these hearings have been scheduled, and we wish to address specifically decreasing the current holding period from 1 year to 6 months, and to offset revenues believed to be lost by coupling such a proposal with the decrease in the current $3,000 capital loss limitation to $1,000.

We believe there is merit in reducing the holding period. The need for mobility of capital in a healthy economy is an economic fact, and any measure that helps or hinders the mobility of capital helps or hinders economic growth. We are aware of the reasons, that is, the Federal budget deficits, and the need for raising revenues for tying the reduction of capital loss figure as an offset to reducing the holding period on capital gains.

However, we feel that the reduction of the holding period on capital gains should stand alone on its own merit. It is a separate issue. We understand that several brokerage firms have reportedly surveyed their customers and have stated that their customers would be willing to have a reduction from $3,000 to $1,000 on capital losses against ordinary income if that were the only way the holding period could be reduced.

This has not been our findings. We have conducted telephone samplings of our membership and found that the $3,000 figure on capital losses against ordinary income is very important to them, and I would like to read an excerpt from a letter that I have from Thomas E. O'Hara, the chairman of the board of trustees of the National Association of Investment Clubs. I will just read a part of it.

> After your call, we polled the 17 people who came in the office to pay their dues, seven presidents of our regional councils who service about 16,000 of our members in larger cities, and a group of miscellaneous investors to whom I had been asked to speak last night.
>
> The reaction was strong and uniform. The reduction of the holding period to 6 months from 1 year would be nice, but not at the expense of reducing the opportunity of charging off $3,000 of capital loss to $1,000.

Now, granted, the stockholder population in America represents a wide variety of incomes, backgrounds, and interests. Therefore, it is conceivable that the opinions of stockholders would differ. A stockholder with a large portfolio and in a high-income tax bracket may not consider the difference between a $3,000 reduction and a $1,000 reduction very important. However, the $2,000 difference can be very important to the smaller stockholder, particularly those with a limited income—you know, the little guys.

This would be a disincentive at a time when stockholders are returning to the market. It must be emphasized that the terms "individual stockholders" and "small stockholders" are not synonymous. The common bond, of course, is that they are equity investors. They have an individual and a collective stake in our capitalistic economic system, and they have put their capital to work. In the true sense of the word, they are capitalists. They are the capital force of our country.

Publicly owned corporations not only want them, they need them. They need their working capital. Eighty percent of the individual investors are long-term stockholders. Less than 20 percent are considered traders. Individual stockholders' pattern of investing differs from the large financial institutions. They invest often in the smaller, usually, I would say, in the smaller, high venture sum and high risk companies, but they are needed.

They are needed for liquidity and for true option in the realistic value of stock, and the success and strength of our free enterprise system comes from this large and varied ownerships' base, yet investors are heavily and unfairly taxed. We still have a heavy tax on capital gains, and double taxation on dividends, and for a country which depends on the capitalistic system, it is an enigma why its Government continues to persist in mistreating capital.

The Government's treatment of capital is a vital concern to the investor and a major influence in investment patterns. Now, I have all of the statistics here of the people, how much venture capital came in, and how much new equity issues came in after the capital gains tax, but I do not want to bore you. You have been through that all day. So let me just say that we really do have a roll going, a momentum going, and a growth going, and we do have it here, and it is a pretty good one, and we feel that it is just not the time to introduce a disincentive to the stockholders.

Thank you for your attention. I am sorry we kept you so long.

[The prepared statement follows:]

STATEMENT OF MARGARET COX SULLIVAN, PRESIDENT, STOCKHOLDERS OF AMERICA, INC.

Mr. Chairman and Members of the Committee, I appreciate the opportunity to appear again before this distinguished Committee on behalf of Stockholders of America, Inc. My name is Margaret Cox Sullivan and I am President of this 12-year-old National non-profit, non-partisan membership organization representing the interests of the over 32 million stockholders owning stock in all publicly held American corporations. Today I am also speaking for the 95,000 individual stockholders in the National Association of Investment Clubs—a segment of the 32 million.

We are grateful that these hearings have been scheduled to consider the "broad range of issues surrounding the taxation of capital gains," to address specifically decreasing the current holding period from one year to six months and to offset revenues believed to be lost by coupling such a proposal with a decrease in the current $3,000 capital loss limitation to $1,000. We believe there is merit in reducing the holding period. The need for mobility of capital in a healthy economy is an economic fact. Any measure that helps or hinders the mobility of capital helps or hinders economic growth.

We are of the reasons, i.e., the Federal Budget deficits and the need for raising revenues for tying the Reduction of Capital Loss figure as an offset to reducing the Holding Period on Capital Gains. However, we feel that the Reduction of the Holding Period on Capital Gains should stand alone on its own merit. It is a separate issue.

We understand that several brokerage firms have reportedly surveyed their customers and have stated that their customers would be willing to have a reduction from $3,000 to $1,000 on capital losses against ordinary income, if that were the only way the hold period could be reduced. This has not been our findings. We have conducted telephone samplings of our membership and find that the $3,000 figure on capital losses against ordinary income is very important to them. Granted the stockholder population in America represents a wide variety of incomes, backgrounds and interests; therefore, it is conceivable that the opinions of stockholders would differ.

A stockholder with a large portfolio and in a high income tax bracket may not consider the difference between a $3,000 reduction and a $1,000 reduction very important; however, the $2,000 difference can be very important to the smaller stockholder, particularly those with a limited income. This would be a disincentive at a time when stockholders are returning to the market.

It must be emphasized that the terms "individual stockholders" and "small stockholders" are not synonymous. The common Bond, of course, is that they are equity investors. They have an individual and a collective stake in our capitalistic economic system. They have put their capital to work—in the true sense of the word, they are capitalists. They are the capital force of our Country. Publicly owned corporations not only want them, they need them. They need their working capital. Eighty percent of the individual investors are long-term stockholders; less than 20 percent are considered "traders."

Individual stockholders' pattern of investing differs from the large financial institutions. Fund managers, either because of regulations or fiduciary responsibilities, invest primarily in the well-established companies and for the most part in a favored few. The individual, in his own frame on interest and judgment, with his own capital, may make investments in the smaller, often more venturesome high-risk companies—which may become the General Motors, the IBM's or the DuPonts of the future.

These millions of differing individual decisions made daily in diversified market transactions are needed for liquidity, for a true auction, and a realistic value of stocks. The success and strength of our Free Enterprise System comes from this large and varied ownership base, yet investors are heavily and unfairly taxed. We still have a heavy tax on capital gains and double taxation on dividends. For a country which depends on the capitalistic system, it is an enigma why its government continues to persist in mistreating capital.

The Government's treatment of capital is of vital concern to the investor and a major influence in investment patterns. This was clearly shown in the increase in new capital raised through new equity issues, initial stock issues and venture capital raised after Congress enacted the Revenue Act of 1978 which reduced taxes on capital gains for both individuals and corporations. Investors came back into the market. The enactment of the Economic Recovery Act of 1981, further lowering the tax on capital gains, resulted in even more activity.

The net new equities issues in 1977 and 1978 were almost flat, and now the estimated figure for 1983 is $32.3 billion. Initial stock offerings in 1977 amounted to $276 million and now are at the $4 billion figure for the first half of 1983.[1] That kind of new capital put to work in our system creates jobs and plant improvements.

Analyzing the market activity from another standpoint, on August 18, 1982, volume soared above 100 million shares for the first time, actually nearly 133 million were traded, shattering the old record by 40 million shares at the New York Stock Exchange. Since then and through September of this year the volume has averaged nearly 85 million shares a day and exceeded 100 million shares fifty-two times, peaking at 149.4 million on November 4, 1982. Reported volume for the year 1982 was almost 39 percent above the 1981 record. The volume has been 55 percent higher in the first eight months of 1983 than in the same period in 1982. The New York Stock Exchange composite stock index from August 1982 through September has risen 65 percent. According to an economist at the New York Stock Exchange, personal wealth in the United States has increased by some $600 billion. This will be reflected in Treasury Revenues for the year.

We have an economic momentum going. It is not the time to introduce a disincentive.

Thank you.

Mr. ANTHONY. That's fine. We are here, to hear your testimony. Mr. Matsui.

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[1] New York Stock Exchange figures.

Mr. MATSUI. Thank you very much, Mr. Chairman.

Ms. Sullivan, I appreciate your testimony very much. I think what you indicate is right on point. It was the point that both Mr. Chapoton has made, and myself, and a number of other people on this panel have made also. The fact that the $3,000 to $1,000 ordinary-income setoff would be a disincentive to be traded off for the potential gain in the capital gains makes very little sense.

This is not the first time the SIA has attempted to hold hostage pieces of legislation to their own advantage. In 1981, they traded off the 6-month holding period in support of the President's tax bill, which basically helped those in the higher income groups, and so this is not the first time that they have used these tactics.

Last December, during the lameduck session, they held up a bill of mine that was attached to the gas-tax bill in order to try to get the 6-month holding period as well. So, this is not the first time that the SIA has engaged in these tactics. They have not been able to win it on its merits, and so they are trying to make tradeoffs in other substantive, perhaps good pieces of legislation.

And the concern I have, and the reason that I came back specifically to talk with you is, I am afraid that they may start a mail campaign. They have 200 cosponsors. I am afraid they may start a mail campaign in which they are going to try to intimidate the Senators and House Members. I think that they may be better than that, but they may attempt to do that, and I think that you and your organization ought to get the message out to your stockholders about what they are really trying to do.

That is, hurt the small investors to help the institutional investors. And I really think that you have to get that message out early so that people are not misled, and I am afraid that you may end up losing the $3,000 to $1,000 issue unless you begin to mobilize your efforts.

And so, I commend you for your testimony today, and I think it is right on point, but this is not the first time that this has happened with some of the representatives of the SIA. Frankly, I am tired of it, and I do not want to see this happen too much again in the future.

Mr. Lasch, let me just make one observation. Whenever we come in the hearings, everybody wants a reduction, and your organization, which I find to be one of the best organizations in Washington, D.C., incidentally, and I have found the information you people provide to be very good, but if there were a tradeoff between R&D credits, which we passed in 1981, and some of the other issues that Mr. Shannon and Mr. Frenzel and myself are working on on behalf of the high tech industries, or the capital gains holding period, what would your observations be on this, because of the deficit issue?

Mr. LASCH. Very clearly, our position is that we fully support the R&D tax credits to the exclusion of this legislation if that is necessary.

Mr. MATSUI. Thank you.

Ms. SULLIVAN. May I say something, sir?

Mr. ANTHONY. Ms. Sullivan, we would most certainly give you an opportunity to respond to Mr. Matsui's question.

Ms. **Sullivan**. I just want to thank him for his good advice, and we will try to do it. We will. We will not try. We will. We have done things like this before. There are 32 million stockholders, and they feel deeply about it, and that is why I am here.

Mr. **Matsui**. Right. I appreciate that, because I think the word out now is that we want to reduce the holding period to 6 months, but the other aspect of it has not been sent out to the shareholders of America, and I think they have to know about that. Thank you very much.

Mr. **Anthony**. I am not through with you. I knew Mr. Matsui came back to make that statement. That is the reason that I yielded to him first, so that I would have the last statement. That is the advantage of chairing the hearing.

I want to make one point very clear. Your statement, Mr. Lasch, did not specifically address H.R. 2225, which is the bill I introduced or its counterpart as amended. Before any letterwriting campaign was generated by the SIA, H.R. 2225 had over 200 cosponsors. So if we had initiated a massive letterwriting campaign we could probably get 18 more Members to cosponsor H.R. 2225, and have a clear majority. Nevertheless, over 200 Members in the House already, on their own merit, understand the need to reduce the holding period.

What is your personal viewpoint based on the history of starting these companies and needing to unlock capital and the formation of capital on the holding period. Are you for it or against it?

Mr. **Lasch**. Well, I personally am for it. The American Electronic Association's position is sort of neutral in that there are so many other issues that are more important to the high technology industry than the holding period, but in general, I personally am in favor of it.

Mr. **Anthony**. What about you, Mr. Neece? You are really talking more about the need for broader rewrites than the capital gains area. What about this additional small correction of reducing the holding period from 12 months to 6 months? Are you personally for it or against it?

Mr. **Neece**. Mr. Chairman, the association is specifically endorsing that provision. The reason is it increases the velocity of capital, the flow of that capital, and therefore the liquidity on the other end. That is where the payoff is for venture capitalists. If our investees, the companies in which we invest, do not have the opportunity or see the window to go public at some later date, that really serves as a serious impediment on the whole venture capital, capital formation process. We would view your bill specifically as a help in that area.

Mr. **Anthony**. Thank you very much.

Ms. Sullivan, the point that I wanted to make, and would ask my colleague, and good friend, Mr. Matsui, to take into consideration some of the following facts. The chart that he mentions on page 14 of the Joint Committee report does show, if you take the incomes under $10,000, $10,000 to $20,000, and then $20,000 to $30,000, and add up the percent of total distribution of tax returns filed, they do represent 30 percent of the tax returns that have come in, and in your testimony you do talk about the tremendous volume that has shown up on the markets, and a more recent study by the exchange itself shows over the last 5 years we have 22 percent new investors into the market, and we are getting more people into the market than we have ever had before, and, Mr. Neece, they attribute that to the fact that we did reduce the capital gains treatment so that it did encourage people to come into the market.

But before you get that letter out, I wish you would take a look at this chart and maybe read the report and then also the chart that is on page 6, I believe. The net tax change if you are under $10,000 is only $23 for the entire year. The net change between $10,000 and $20,000 is only $52 for the entire year. For $20,000 to $30,000 investor, the net tax change, if I understand this correctly, is $68, and correct me, staff, if I misinterpreted this particular chart, because it lays the premise for the point that I am trying to make, and it also shows you the difficulty that we have as legislators.

Ideally, I had rather have the holding period in my original form, H.R. 2225, and not address it in any other way, but I ran into a problem, not only with the chairman of this committee, but other Members in the House who were concerned about the deficit. So we had to find some way to make sure that it was absolutely revenue neutral and/or revenue positive. So in researching the history of the legislation, I found that we had the $1,000 offset for many, many, many years, and it was only as a tradeoff to get the capital gains reduced that it was phased up over a 2-year period of time back in 1977.

So, all I am trying to do now is really flip-flop and go back to pre-1977 law, and let me tell you what I think the dynamics are that will occur to your investors, the people that you actually represent. By the fact that they would have a 6-month holding period, they are going to be given total flexibility or greater flexibility when to trigger a capital gain than they are if they have to hold it for 12 months.

I have put together and I wish that I had them here to show you now, but I put together some charts or had them put together for me, and as you slide the scale across, you can take practically any stock as it goes up and down over a 12-month period, and sometimes during that period of time you would be able to sell and trigger a gain, but just in stock, after stock, after stock you could try this and you could put it on just about any date, any month of the year, but during that course of time invariably it was going to dip down below that price.

So, from a timing standpoint, you were given much more flexibility on the 6-month than you were on the 12-month, and looking at that chart was one of the main reasons that I became convinced that the average and the small investor would benefit from this as much as anybody else.

Obviously, the people on the upper end of the scale reap some benefits because they are there and they pay a lot of taxes, and if you look back to the chart that I mentioned to you on page 6, I think there is a very equitable breakout between those people who make $75,000 and below and those people who make $75,000 and above; $75,000 is a lot of money to a lot of people.

The annual average per capita income in my district, for instance, is less than $4,000, so it does seem like an awful lot of money to them, but when you have two wage earners in the family, there are thousands upon thousands of people making up to $75,000 and above, but when you look at the breakout, this proposal does give a very evenly divided split as to who has to shoulder the burden.

So, I think you can look at figures, and you can say that it is being done to hurt the small investor, and you can pull out some figures and try to make that argument, but I think if you look at the total mix, that you can see that it was not done to hurt the small investor, but it was in fact done to try to give total flexibility in an era where we do have greater volatility in the market, so that that personal investor could trigger that gain when they wanted to.

If they wanted to hold it for 10 years, they could trigger the gain. If they wanted to hold it for 6 months and 1 day, they could trigger the gain. That would take care of your people who you say hold on for the long term, and it would take care of those new investors that are coming in with a volatile market.

So, if you do get out the letters to the Members of Congress, I would ask you to take a very close look and at least make it a very fair presentation of the facts, and not try to have tunnel vision, because this is something I have wrestled with myself, and I finally came to the conclusion that the better good lay with the amended version, if that was the only way that we could get it passed, albeit if I were the czar I would pass it in its original form, but I just did not find that kind of atmosphere in the Congress.

I want to thank you for your participation and your help in establishing the record on all these important issues.

Mr. Barnes, do you have a closing comment?

Mr. **Barnes**. Just one thing I overlooked. On dividend income, there are capital gains and nontaxable portions in many companies, and I would like to have your permission to introduce into the record some forms that I have devised, schedule B, to make it easier for the Treasury Department and the taxpayer to verify returns with 1099's and reporting dividends. This form provides extra lines to list capital gain and nontaxable portions received from each company.

The IRS now receives numerous copies of 1099's that may be entirely different than what is reported by the taxpayer. This void in present returns is corrected by an extra column showing the gross amount received on each dividend payment, the nontaxable and capital gains portions, and then the net taxable dividend. Also, it will avoid a lot of verification and administrative costs. This schedule is slightly changed to a horizontal one instead of vertical in order to permit space to make quick comparisons with 1099's.

With the present schedule B, it is not possible to make comparisions of many income items. For example, I had a case the other day where a taxpayer bought some Government bonds and paid out $5,600 in accrued interest and on November 15 will receive an interest payment of $6,000. There are columns to report the gross interest source of $6,000, accrued interest paid of $5,600, and the difference of $400, or the net income actually received.

Mr. **Anthony**. Do you have a document there?

Mr. **Barnes**. I have them all documented here, and I ask your permission to put them in the record, because I think they could be very helpful to both the IRS and the taxpayers of this country. Also, there are revisions in schedule A—deductions from income—to make space to list the name of the recipient and tax identification or social security number. This is provided to disallow any interest deduction if copies of payors 1099's are not attached.

Mr. ANTHONY. Mr. Barnes, without objection, we will attach it as an exhibit to your prepared testimony. It has been accepted for the record.

Ms. Sullivan, before you close, as I was reading through that, I did have a personal fear that I may have been misinterpreting that chart. It is on page 14, and I did misinterpret it, and I want to clarify the statement. The average additional tax increase, by reducing it from $3,000 to $1,000, if you are under $10,000, would be $186. I have quickly done some figuring over here.

If lowering the capital gain—the holding period from 12 months to 6 months—gives you the opportunity to unlock some tied-up gains and to guarantee that you are going to trigger a gain rather than a loss if you have to hold it for an additional 6 months and not know what the future holds, all you have to do is trigger an additional $950 in gain at the 20 percent to completely offset that.

That is fairly insignificant, I think, when you start talking about the type of investments that people make in the stock market, so I think there is a good tradeoff there. All I ask you in working with your association, inasmuch as we are all trying to encourage investment, savings, and capital formation, is to take a close look at where that actually breaks out.

Ms. SULLIVAN. Thank you very much for your interest. I really appreciate it, and I will do what I am supposed to do.

Mr. ANTHONY. I thank the panel for their participation in the hearing today. Mr. Neece.

Mr. NEECE. I would like to be afforded the opportunity to correct page 3 of our formal submitted statement. We have some typographical errors.

Mr. ANTHONY. Without objection, you can straighten those out. Thank you.

Our final panel is Mr. Oscar S. Pollock, limited partner in Ingalls & Snyder; Thomas Ruhm, vice president and assistant general counsel, Bessemer Securities Corp.; Janice M. Johnson, coordinator, national tax practice, Oppenheim, Appel, Dixon, & Co.; and Steven C. Thompson, CPA, professor of taxation, University of Houston at Clear Lake City.

Thank you for joining us, and we will accept your testimony in the order in which you were called to the witness table, so that would be Mr. Pollock, Mr. Ruhm, Ms. Johnson, and Mr. Thompson. We will accept your prepared testimony for the record, and you are authorized to proceed as you see fit.

STATEMENT OF OSCAR S. POLLOCK, LIMITED PARTNER, INGALLS & SNYDER

Mr. POLLOCK. I am Oscar Pollock. Do you want me to speak first?

Mr. ANTHONY. Mr. Pollock, we are going to let you go first.

Mr. POLLOCK. OK. Mr. Chairman and members of the committee, my name is Oscar S. Pollock, and I am a limited partner of Ingalls

& Snyder, who are members of the New York Stock Exchange, and I appreciate the opportunity to testify on behalf of my firm.

Mr. Chairman, in the interest of saving time for you, perhaps my formal statement could be put in the record, and I will just summarize it in a few sentences. Would that be agreeable to you?

Mr. ANTHONY. Without objection.

Mr. POLLOCK. I have written extensively on this subject of the need to lower capital gains taxes in the past and I just want to emphasize one point which I feel is extremely important, and it tends to get overlooked by other analysts of our capital market. That is that in the last 20 years we have had extensive experience with increasing capital gains taxes and in the last 5 years with reducing taxes on capital gains and investment income.

What has been almost uncanny is the way our stock market has paralleled the course of tax rates on individual capital. With my testimony, I submitted a very simple table for you which divides the history of the equity market into three periods. The first period was one of relatively favorable capital gains tax treatment. The second one was a period when capital gains tax rates rose, and that appears to have been an extremely important factor in a 9-year depression in equity values.

The turn came in early 1978 when this committee voted to lower capital gains taxes, and since then we have had an increase in the market value of all equities of over 80 percent, and we have added $800 billion to the market value of all equities.

Now, what is the significance of that? The significance is that it has done a lot to stimulate the economy in a period when other forces were dragging it down, but perhaps the most important aspect of this improvement has been that it has given a wide range of American companies the chance to do equity financing.

I was reading the Wall Street Journal on the plane coming down this morning, and I saw that the new chairman of our trade association, Mr. Jenerette, said that in the current year, our industry will raise $40 billion of equity capital for American companies. We have never seen a number like that before. The previous record was last year. That was $16 billion. And prior to that, we had years when there were totals of $4 billion, $5 billion, and $6 billion.

So the point is, we are doing a lot of things right in the area of capital gains taxes, and the important thing is to keep the momentum going and to keep lowering the tax on individual capital, and the holding period reduction is a very significant step which will make investing more attractive for individual investors. The best rationale for it came from a client of mine in Chicago who said the world has just become too risky for a 1-year holding period.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF OSCAR S. POLLOCK, LIMITED PARTNER, INGALLS & SNYDER

SUMMARY

Experience with recent tax reductions for individual investment has been extremely successful. Equity values have risen dramatically and equity financing by U.S. corporations has risen to record levels. The trend of U.S. tax policy should be continued by reducing the holding period needed to qualify for long-term capital gains treatment from one year to six months.

STATEMENT

Mr. Chairman, and Members of the Committee, my name is Oscar S. Pollock. I am a limited partner of Ingalls & Snyder, members of the New York Stock Exchange. Thank you for the opportunity to testify on behalf of my firm.

Over the past six years, I have written extensively on the need to lower capital gains tax rates and other taxes on investors. With this Committee's leadership, a lot of progress has been made in these areas.

One aspect of these tax changes that has not received the attention it deserves is their overall impact on equity values. In considering our stock market, trading activity should not be confused with stock ownership. For example, most of the activity in the largest market—the New York Stock Exchange—results from purchases and sales by institutional investors, many of whom are not subject to income taxes. But the "Household" sector still owns over two-thirds of all equities. Moreover, individual ownership of equities is concentrated in the upper income groups, which are very sensitive to tax considerations and tax changes.

Changes in the tax treatment of capital gains and investment income alter possible after-tax returns for individual investors. Such fundamental shifts in the potential after-tax returns are reflected in the value of equities. Obviously, tax changes are not the only factors which affect equity values; they combine with other influences on the stock market and this makes their impact difficult to measure precisely. But the fact that one cannot measure these tax effects precisely does not mean that they are not important.

My testimony contains a simple table which divides the record of the equity market into three periods. It is almost uncanny how the performance of the equity market correlates with the trend of tax rates on individual investors. The table shows that a nine-year depression in equities began in 1969, when tax rates on individual capital were raised significantly. At the end of 1977, the total market value of all equities was below the 1968 level, and after adjustment for inflation, equities lost 40 percent to 50 percent of their value. The U.S. equities depression ended early in 1978, when this Committee voted to lower capital gains tax rates. The pivotal 1978 tax change was, of course, followed by other investment tax reductions. Between the close of 1977 and the end of 1982, the market value of all equities has risen over 80 percent. Over $800 billion has been added to the market value of equities.

What is the significance of this dramatic improvement? First of all, it has helped to stimulate our economy when other forces were dragging it down. Secondly, the higher equity values that have materialized in recent years have made greater equity financing by American industry feasible once again. Record amounts of capital are flowing into new, small and rapidly growing companies and total equity offerings by U.S. corporations will reach a new peak this year. All this added investment has created new job opportunities at the lowest cost to the taxpayers.

Changes in taxes on individual capital have an enormous leveraged impact on the health of our economy. Our economic system depends on private capital. When the tax laws restrict the flow of individual capital to the most productive channels, there are widespread adverse effects on the economy. As the tax burden on that capital has diminished, the positive results have exceeded anyone's expectations.

For the future, we should build on successful tax policies! We should continue to progressively reduce tax rates on capital gains and investment income. And make no mistake about it, our tax rates in these areas are still among the highest in the world. Reducing the holding period needed to qualify for long-term capital gains tax treatment from twelve months to six months is a logical next step. It continues the tax policy of making investing, and particularly equity investing, more attractive to individual investors. Equity investing involves significant risks under the best of circumstances, but the pace of change throughout the world has just become too rapid for a one-year holding period. If the history of recent tax changes is any guide to the future, and we believe that it is, this reduction will have disproportionately positive implications for individual investment and job creation.

Corporate equities—total at market value

	Billions
Phase No. 1.—A period of relatively favorable tax treatment for long-term capital gains:	
1959	454.0
1960	451.0
1961	574.0
1962	505.7
1963	597.0

1964	662.1
1965	749.0
1966	682.2
1967	868.2
1968	1,032.6
Phase No. II.—A period of rising tax rates on individual capital:	
1969	913.9
1970	906.2
1971	1,059.2
1972	1,197.2
1973	948.1
1974	676.9
1975	892.5
1976	1,052.0
1977	991.3
Phase No. III.—Tax rates on individual capital are progressively reduced:	
1978	1,034.2
1979	1,231.3
1980	1,635.9
1981	1,568.5
1982	1,810.2

Source. Federal Reserve Bank: Flow of Funds, Year-end outstanding.

Mr. ANTHONY. Thank you very much. I must admit that this is a point that I have heard over and over again in talking to people. Congress has deregulated so many of our institutions and industries, that this volatility has been created.

Our next witness is Thomas F. Ruhm.

STATEMENT OF THOMAS F. RUHM, VICE PRESIDENT AND ASSISTANT GENERAL COUNSEL, BESSEMER SECURITIES CORP.

Mr. RUHM. My name is Thomas Ruhm, and I am vice president and assistant general counsel for Bessemer Securities Corp. in New York City. Bessemer is a privately held investment company and is probably impacted more by capital gains taxes, at least relatively speaking, than any other institution in the country. We do a great deal of private investing. We have a marketable portfolio, and so forth.

My reason for being here today is not to testify on any of the propositions or bills that are before the committee, but simply because the press release referred to the broad aspects of capital gains being discussed so as to form a background for the specific proposals. I felt it was incumbent upon me to come and lend my knowledge of the broad aspects of capital gains to the transcript of these hearings. I am assuming that the written statement that I have submitted will be incorporated in that transcript, and I will not repeat much of what is in there.

I would like to read one statement which I think sums up almost all the way what has happened as a result of lower capital gains taxes since 1978. This statement was made by E. Wayne Nordberg, who is an independent, I will say, at least independent of the venture capital process, economist for the firm of Prescott, Ball & Turben in Cleveland, Ohio. I have never met Mr. Nordberg, but I really could not have written this statement better myself. It appeared in early July of this year. And I quote:

> From the Atlantic to the Pacific, a new grass roots capitalism is springing up in the United States. An army of entrepreneurs, financed by a seemingly endless flow of venture capital, is just beginning to aggressively push the benefits of dramatically

enhanced electronic technology into the consumer/home/communications marketplace.

The production process on the factory floor is also due to be radically transformed as the cost of remote capture and processing of information plummets. The uniqueness of this dynamic phenomenon can only be properly appreciated when contrasted with the sterile state socialism or corporate oligopoly domination of industry in Europe. Their systems are obsolete on the fast track of electronic technology. Even the Japanese will be limited to a few giant successes by their centralized, top-down determination of technological priorities.

No other country is structurally capable of producing and financing the myriad of new businesses that are pushing the pace of innovation today in the United States, and it is to this process that we must look if we are to offset the secular decline in our basic industries.

The reference to basic industries reminds me of the discussion that has gone on this morning from time to time about whether we should benefit small companies at the expense of big companies. As I was listening to it, I was thankful that I would have the opportunity to in some cases point out and in other cases reinforce points made before to the effect that when the stock market is booming, as it has been, the prices of the stocks of large industrial companies rise just as much as the small ones, at least if you take overall stock values that are involved. Through this rise in stock prices large companies are able and have been able through public offerings of their securities to refinance their vast amounts of short-term debt.

That short-term debt was a real problem for this country 15 months ago, and I submit that it is much less of a problem today, thanks to the statistic that Oscar Pollock just quoted about $40 billion in public equity financing in 1983 so far. That did not all go to small companies, I assure you. In fact, I would venture to guess that less than half of it went to small, high tech companies.

Furthermore, big business can draw more upon their retained earnings thanks to the effect of the differential in capital gains tax rates compared with those on ordinary income, which makes the stockholders of big companies look less for dividends and more for price appreciation in the stocks that they own. That means that the management of big businesses can and have retained more of their earnings to do, first of all, more R&D, second, more product development, and third, more investing in new plant and equipment that is capital investment. That last aspect has not been strong until just recently.

We are hearing more and more as we get to the proper point in the business cycle that the capital investment amounts are increasing substantially in recent weeks, and economists expect capital investment to be a very strong item through the winter and into next year.

Finally, I do not think it hurts big business to have little business come along and compete with it. I have a couple of very strong cases where big businesses sat on technologies that they could have easily developed themselves because they had such a large capital investment in the prior technology. It took the little guys to come along developing the new technology and present a competitive threat that made the big guys leave their vested interest in the prior technology and adopt the new technology. The two that I have in mind are core memory, which IBM sat on for a long time instead of developing silicon chip memory technology, which the small companies did, and also AT&T's failure to create a data transmission network using packet switching technology. Such a network would have been much more cost effective for their customers, who until the network was installed, and it was installed under threat of competition from a much smaller company, could only rent entire lines to speak between Los Angeles and New York or anywhere else. They had to rent the whole phone line while they were making a data transmission.

So, I think that big businesses definitely benefit. The country benefits. I do not think this is a discrimination in favor of small companies. I think it is more dramatically shown that the first people to benefit in a sense are the small companies. They are more visible. They are more flexible. They can move and respond more quickly to the availability of capital.

But in the long run, in the not very long run, big businesses benefit from it just as much. Thank you.

[The prepared statement follows:]

STATEMENT OF THOMAS F. RUHM, VICE PRESIDENT AND ASSISTANT GENERAL COUNSEL, BESSEMER SECURITIES CORP.

SUMMARY

1. Individuals Pay Tax at a Maximum Rate of 50 percent on Ordinary Income and 20 percent on Realized Long-Term Capital Gains. Corporations Pay Tax on Ordinary Income at a Maximum Rate of 46 percent and on Realized Long-Term Capital Gains at a Maximum Rate of 28 percent. This is What We Refer to as the "Differential" Between Rates of Tax on Ordinary Income and Those on Capital Gains.

2. New Capital Commitments to Organized Venture Capital Investment Vehicles Have Increased From an Average of $70 Million Per Year During the Period From 1969 to 1977 to an average of $1.4 Billion Per Year During the Period From 1978 Through the Third Quarter of 1983. This is the Nation's "Seed Capital".

3. Initial Public Offerings by Companies With Less Than $5 Million of Net Assets Have Increased From 25 Per Year During the Years 1973 to 1978 to 150 Per Year During the Period 1979 Through the Thrid Quarter of 1983.

4. The "Differential" Makes Growth Stocks Attractive Through a Lower Effective Tax Rate on Growth Stock Investments.

5. The "Differential" Induces Corporations to Plow Back Profits Into Research and Development and New Plants and Equipment Because There is Less Demand for Dividends and More Demand for Increases in Stock Price by Shareholders.

6. The Nation's Research and Development is Growing at a Real Rate of From 3 Percent to 5 Percent Per Year Starting with 1976 (Then Due to the Energy Crisis) and Continuing to the Present (Due to the Lower Rate of Tax on Long-Term Capital Gains). We Are Seeing the Beginnings of a New Growth in Capital Spending.

7. Ther Beneficiaries of Lower Capital Gains Taxes Are Not Only Entrepreneurs, Their Employees and Investors, But Also the Country at Large, Benefiting From Increased Technological Development, Healthy Competition For Large Companies From Small Growing Companies, Excellent Sources of Jobs for Our Energetic Young People, Increased Productivity and a Renewed World-Wide Reputation for Developing Technology.

8. Consideration Should be Given to Reducing the Tax on Long-Term Capital Gains to Zero.

9. The Rate At Which Corporations Presently Pay Tax on Realized Long-Term Capital Gains Should Be Reduced From 28 Percent to the Maximum Rate at Which Individuals Pay Tax on Such Gains (Presently 20 Percent).

10. Tax Cost Bases For Determining the Amount of Capital Gains Realized Should Be Indexed For Inflation.

11. Whether the Holding Period Is One Year or Six Months Does Not Materially Affect the Incentive For Long-Term Equity Investing Created by Lower Capital Gains Taxes.

STATEMENT

The capital gains tax differential has been called "the goose that lays the golden eggs". Why? The present maximum effective capital gains tax rate for individuals is 20 percent, while the present miximum rate of tax on dividends and other forms of ordinary income received by individuals is 50 percent. Comparable figures for corporations are 28 percent and 46 percent. When differentials such as these exist between the tax rates on dividends and the tax rate on long-term capital gains, investment capital moves steadily into situations that produce capital gains rather than those which produce dividends or interest. The more dynamic the production of long-term capital gains the better.

What this has meant, among other things, is that since the dramatic reduction in capital gains taxes effective in 1978, the amount of new private capital committed to venture capital firms (which are those firms which invest in new small companies with a growth potential) has risen substantially from an average of only $70 million per year during the period from 1969 through 1977 to an average of $1.4 billion per year during the period from 1978 through September 30, 1983. The funds committed during the most recent complete years were $1,300,000,000 in 1981 and $1,700,000,000 in 1982. The President stated in a recent radio address that $2.5 billion has been committed to venture capital firms so far in 1983 through September 30. This is the nation's "seed capital" from which hundreds of new businesses are started each year.

As can be seen from the attached table, as one would expect, the growth of these firms' disbursements of investment capital to portfolio companies has kept pace with the growth of capital committed to the investment firms themselves. Venture capital investments are made principally in companies developing high technology products. This is because greater returns can be achieved in high technology businesses with lesser amounts of capital than is the case with companies requiring considerable heavy equipment and other major capital assets.

Also due to the capital gains tax differential, many of these young high-tech companies have had their initial public offerings during the years since 1978. During the years 1979 to 1982 there occurred an average of 150 public underwritings per year of companies with a net worth of $5 million or less. 1983 has certainly seen an increase from that average. The comparable figure for the years 1973 to 1978 was 25 such public underwritings per year.

These underwritings were made possible by a remarkable increase in the appetite of the public stock market for securities of high-tech companies. Few if any of these companies pay any dividends. Their stocks are made attractive by the lower rate of tax on the return for such investments due to the capital gains tax differential. People receiving dividends from established companies must include them effectively in the top brackets of their taxable income, e.g., in many cases 50 percent. People who do not receive dividents but participate in the growth of the market prices for stocks that they own can simply sell a few shares to raise the same amount of money as a dividend would pay them and pay only a 20 percent tax on the profits from so doing.

Because of this phenomenon even large established companies, to keep the market prices of their stocks up, have changed their policies to act more like growth companies and have plowed back increasing amounts of their earnings into corporate growth. Over the years since 1978 these plow-backs have primarily consisted of conducting increased research and development. This can be determined from the fact that research and development in this country has been on the increase starting with the year 1976 at real rates of from 3 percent to 5 percent (i.e., adjusted for inflation) per year. The early years of these increases were principally attributable to the energy crisis, but the later years seem to be more attributable to the phenomenon discussed above since the energy crisis has substantially waned.

Large corporations also attempt to achieve growth stock status by constructing new plants, modernizing their existing plants and equipment and so forth. However, these heavy capital expenditures have not been deemed feasible during the five years since 1978 because of sluggish economic conditions. In the last few weeks there have been increasing references in the financial press to the beginnings of increases in capital spending for plant and equipment. These generally occur after markets have sufficiently expanded in an economic growth cycle so that company managements can decide that there is sufficient potential to merit increasing their productive facilities for given products. When they do occur in the months ahead, they will be substantially greater, in my opinion, because the significant differential between the tax rates on long-term capital gains and those on ordinary income is causing companies to plow back more of their profits instead of paying them out in dividends.

This tilt towards long-term growth and investments caused by the capital gains tax differential came to me one day somewhat like Isaac Newton being struck by a falling apple while sitting under a tree. One day, early in my investment career, I was wondering how it was that IBM could get away with paying little or no cash dividends (they paid substantial stock dividends) while the oil and steel companies and others were paying substantial cash dividends. Why would IBM stock be attractive to investors if it were not paying any dividends or even advertising that it planned to pay dividends (this was in the early Sixties). And then it occurred to me that with the maximum tax rate applied to dividends at that time being 91 percent and the maximum tax rate applied to long-term capital gains at that time being 25 percent, the holders of IBM stock did not want dividends, but merely sold some of the shares that they had, in ever increasing numbers thanks to the many stock splits and stock dividends effected by IBM, in order to raise any cash that they needed.

I could readily see that the effect of this capital gains tax differential was to assist companies like IBM to retain and plow back their profits into new investments, including new research and development, instead of having to pay it out in cash dividends. I then remembered from my college economics course that the investment dollar had a substantial multiplier effect as it was spent and respent throughout the economy. Therefore, I naturally concluded that there were some very intelligent minds at work behind the structure of our tax system, which at that time (the Fifties and Sixties) was causing tremendous reinvestment of profits and tremendous growth in our entire economy.

Unfortunately, in 1969 Congress began to eliminate the capital gains differential strictly for reasons of tax equity (I do not believe that the excellent effects of the differential were fully understood at that time). In that year Congress limited the 25 percent rate to the first $50,000 worth of realized long-term capital gains and applied a 35 percent rate to all gains over that amount. When federal preference taxes and state income taxes were taken into account, it was not unusual after that time to find people paying an effective tax on long-term capital gains at the rate of 40 percent. In 1976 Congress tightened the noose on the golden goose much tighter by putting substantial teeth in the federal preference tax, which had the effect of raising the maximum federal rate to about 49.5 percent. This when combined with state income taxes produced a maximum effective tax on long-term capital gains of upwards of 55 percent. You can see from the attached table, some of whose information I have referred to above, the bad effects that these moves had on venture capital investment and the market for new public issues of growth stocks.

In 1978 the unfortunate trend to eliminate the capital gains tax differential was totally reversed. Capital gains were eliminated as a tax preference item, and the deduction for capital gains was increased to 60 percent. This produced an effective federal rate of 28 percent on realized long-term capital gains. Combined with state taxes, the effective rate was somewhere around 32 or 33 percent. The stock market reacted immediately to the prospective passage of this legislation. Growth stock prices rose dramatically in the spring of 1978, when more than 60 Senators indicated they would vote for a substantial capital gains tax reduction and Representative Bill Steiger indicated he had a majority of the House Ways and Means Committee prepared to do the same thing.

In 1981 a further reduction in the effective capital gains tax rate was brought about by a lowering of the maximum tax on all individuals' income from 70 percent to 50 percent. This also automatically lowered the maximum federal tax rate on long-term capital gains from 28 percent to 20 percent. This lowered the maximum effective rate combined with state income taxes to around 25 percent.

Who benefits from lower capital gains tax rates? Clearly small companies and their personnel benefit directly more than anyone else. We estimate in my company that 90 percent of the capital that we invest directly in small growing companies goes to pay the salaries of those companies' personnel. They in turn develop the technology that becomes a marketable, profitable product. We see to it that not only management but all employees of companies in which we invest have substantial amounts of stock or stock options in the companies that employ them. Only in this way can our private equity investments become profitable.

But benefit from lower capital gains taxes does not stop with entrepreneurs, employees and investors. Society at large is a substantial beneficiary also, for the following reasons: First, the new products developed by these young companies bring about a better standard of living for everybody. Secondly, if it were not for the new technology developed by young companies, the larger, established companies would be much slower to shift to newer and more efficient processes and products. Two examples of this are IBM's hesitancy to shift from core memory to silicon chip memory devices because of its huge investment in core memory manufacturing facilities and, secondly, AT&T's reluctance to develop a packet-switching network for data transmission because of the high profitability to them of leasing entire lines, useable by only one party at a time, to companies or persons conducting data transmissions. In both cases venture capital invested in new young companies developed the highly efficient alternative technologies of silicon transistor memory chips and packet-switching networks for data transmission. Eliminate the capital gains tax differential and you will put a substantial damper upon technological development in this country.

Society at large further benefits from the capital gains tax differential through the availability to its imaginative, energetic young people of jobs with smaller, but growing, companies as opposed to jobs only with large or giant companies in which the individual from time to time gets lost completely. Many people work much more efficiently and more happily in a smaller employment situation. The work atmosphere tends to be more dynamic and flexible.

We also benefit from increases in both jobs created and taxes paid (both by corporations and their employees) resulting from the formation of new businesses.

Furthermore, the growth of these small companies does not in any way impede the growth of the large companies. Quite frequently, when a small company has grown to a substantial size, such as $100 million in sales, it becomes an attractive candidate for acquisition by a larger company and subsequently becomes a division of that company. People who prefer the atmosphere of a small company tend to leave companies which have become divisions of large companies for new smaller company employers.

Could straight government subsidies to small business achieve the same growth as the capital gains tax differential? My answer to that is an emphatic "No". Capital gains do not spring automatically from well-intended efforts at creating new technology. They only come where the investment and entrepreneurial efforts have been intelligently directed at a technology that is needed in the large economic market place. It takes professional venture capitalists to ascertain which technologies have that potential and which management teams have the necessary qualities of good management to realize that potential. These men are given the necessary incentives to do their jobs right by competition from other investing groups and by the profit motive. Just spraying government money at small companies will not achieve the quality of results achieved by professional investors.

People who have something to gain from the correctness of their decisions will make better decisions than those who are simply drawing a regular salary. What I am getting at here is that venture capitalists are compensated generally with a substantial share of the capital gains realized from the investments that they make for their firms. The typical split is 80 percent for the limited investors and 20 percent for the working venture capitalists. That gives the venture capitalists the necessary incentive to find profitable enterprises in which to invest the firm's money.

By the same token entrepreneurs are enticed away from the large companies, for whom they typically work prior to setting up their own companies, by the prospects of substantial capital gains to be realized upon the ultimate sale of the stock that they receive in their new companies. But if they fail to make the company grow, they will not receive any compensation in this way. Therefore, there is a strong incentive upon the entrepreneurs to develop their technology successfully. Take away these incentives and you will surely take away much of the rapid technological progress that our country is presently making.

The final area of benefits to society from the capital gains differential, but by no means the least important, is productivity. Productivity is the measure of the rate of output by our country's workers. It was interesting that in the recent General Accounting Office study of venture capital, in which they studied particularly the 72 companies backed by venture capital that had gone public during the period from 1970 through 1979, they found that every one of the products produced by these companies enhanced the productivity of either white collar or blue collar workers. It stands to reason that productivity enhancements produce strong markets for companies' products.

Finally, our worldwide reputation for high technology development has been vastly enhanced over the past five years since the passage of the capital gains tax reduction in 1978. This contributes to our national security and makes our products more exportable, thus enhancing our economic position in the world.

Once you make the rate of tax on long-term capital gains equal to that on ordinary income, you ipso facto lose the capital gains differential. There will be no incentive for companies to plow back profits or to do more R&D. There will be vastly fewer investments in small companies or growth stocks generally. The IBM's and AT&T's of this world will once again become the cocks of the walk and everyone will dance to their tune. If that is what you want, vote to raise the capital gains tax. If you do not want it, keep the 60 percent deduction for realized capital gains—or even raise the deduction to 100 percent (i.e., a zero rate of tax on long-term capital gains).

A further note: There is no sound reason why corporations should pay tax on their long-term capital gains at a 28 percent rate while individuals pay tax on such gains at a maximum rate of 20 percent. Over 50 percent of the capital supplied to the venture capital investing business is supplied by corporations paying a 28 percent tax on their realized long-term capital gains. It would be of substantial assistance to the entrepreneurs and small companies served by the venture capital industry if the corporate rate were reduced to 20 percent. As it is now, corporations are placed at a competitive disadvantage with individuals in investing in venture capital investments because of the disparity in rates. Because they pay only a 20 percent rate on their realized gains, individuals can strike a better deal with entrepreneurs than can corporations. Corporations also have a deduction from their taxable income of 85 percent of all dividends received. This means that there is already a strong incentive for corporations to seek safer, higher yielding stock investments rather than start-up venture capital situations. The fundamental unsoundness and unfairness of this situation should be eliminated by reducing the corporate capital gains tax rate to 20 percent.

One last note: taxing capital gains without indexing the tax cost basis of the assets sold is inherently unfair. In the 1970's it led to people paying substantial taxes on real losses (i.e., taxable gains when adjusted for inflation were often actual losses). The present system of capital gains taxes—and any successor system—must provide tax cost basis indexing to eliminate this problem.

In closing, it should be noted that whether the holding period that qualifies the gain on the sale of a capital asset as "long-term" for the purposes of the lower rate on realized long-term capital gains is one year or six months is immaterial to the incentive required for long-term equity investing. The one year holding period has produced sufficient demand for growth stocks to provide all the incentive needed to create such stock. It is unlikely that reducing this holding period to six months would materially improve this incentive.

VENTURE CAPITAL INDUSTRY—ESTIMATED FUNDINGS AND DISBURSEMENTS

[Dollars in millions]

Year	New private capital committed to venture capital firms	Estimated disbursements to portfolio companies	Public underwritings of companies with a net worth of $5 million or less	
			Number	Amount
1982	$1,700	$1,800	113	$619
1981	1,300	1,400	306	1,760
1980	900	1,100	135	822
1979	319	1,000	46	183
1978	570	550	21	129
Capital gains tax decrease:				
1977	39	400	22	75
1976	50	300	29	145
1975	10	250	4	16
1974	57	350	9	16
1973	56	450	69	160
1972	62	425	409	896
1971	95	410	248	551
1970	97	350	198	375
Capital gains tax increase:				
1969	171	450	698	1,367

Total Capital Committed to the Organized Venture Capital Industry Estimate at December 31, 1982.

	Billions
Independent private venture capital firms	$4.4
Small business investment companies	1.3
Corporate subsidiaries (financial and nonfinancial)	1.9
Total	7.6

This pool remained static from 1969 through 1977 at some $2.5-to-$3 billion (with new fundings more or less equal to withdrawals).

Source: Venture Economics Division, Capital Publishing Corp.

Mr. ANTHONY. Thank you, Mr. Ruhm.

Ms. Janice M. Johnson.

STATEMENT OF JANICE M. JOHNSON, COORDINATOR, NATIONAL TAX PRACTICE, OPPENHEIM, APPEL, DIXON & CO.

Ms. JOHNSON. Good afternoon, Mr. Chairman.

My name is Janice Johnson. I am here on behalf of our firm, Oppenheim, Appel, Dixon & Co., rather than on behalf of any of our specific clients. We do, however, represent many investors and many taxpayers in the brokerage industry. It is because of the experience we have gained over the years in doing their tax planning and in preparing their tax returns that I am here today.

We think that the most effective way to foreclose the gaming currently taking place with respect to capital gains and losses would be to make several substantial changes other than those which are currently before the committee in the manner in which such gains and losses are taxed. First, we would recommend that the holding period necessary for obtaining long-term capital gain or loss treatment on marketable securities be eliminated. This would result in the taxation of all gains on such securities as long-term, even if the securities were held for only 1 day.

Conversely, any loss on such securities would be long term immediately. Furthermore, we would not limit this treatment to marketable securities, but instead we would have it apply to all instruments that are affiliated with marketable securities, that is, stock options, options on indexes, and the like. Instruments such as regulated futures contracts on silver and other commodities would continue, however, to be taxed under the current scheme, which results in 60 percent long-term gain or loss and 40 percent short term.

Treating all securities and securities-related instruments alike would eliminate the tax law's current bias in favor of investment in speculative instruments. For example, an investor in regulated futures contracts can sell those contracts 2 days after their purchase and have 60 percent of any gain treated as long-term capital gain while only 40 percent is treated as short term.

On the other hand, if that investor had put his money into the common stock of a fast growing company, and after holding that stock for 11 months, sold it at a large capital gain, the whole gain would be short term, taxable at a maximum rate of 50 percent. For the astute investor who is receiving sophisticated tax advice, there are, of course, ways to assure that either any gain on the sale of common stock receives long-term treatment or that recognition of the gain is postponed until a later year. It does not, however, seem to be a fair taxing policy that leaves these benefits only to those who can pay for the professional advice necessary to secure them.

Furthermore, setting the holding period necessary for receipt of long-term capital gains treatment at an arbitrary length of time of 1 year, 6 months, or any other period totally ignores the economics of the investment. Making the attainment of long-term treatment immediate would allow the investor in securities to move freely in and out of his investments at the point in time when it is economically sound to do so. This would avoid the current arbitrarily lengthened holding periods used to obtain long-term capital gains as well as the prematurely shortened holding periods used to obtain short-term capital loss treatment.

We would also recommend that capital losses on securities only be usable to offset capital gains on securities. This would eliminate the ability to offset short-term capital gains from the sale of other capital assets such as land or regulated futures contracts involving silver by losses from the sale of securities.

The ability to offset any ordinary income by capital losses should also be eliminated. There is no logic in the current allowance of a $3,000 capital loss against ordinary income, just as there would be no logic in reducing that allowance to $1,000. To compensate for the revenue loss that it may be feared will result from reducing, and therefore presumably also from eliminating, the holding period necessary for achieving long-term capital gains treatment, we recommend that a flat tax at a rate of 25 percent be levied against net capital gains from the disposition of securities. This is a slight increase from the current 20-percent rate of taxation imposed on such gains, and it seems likely that this 5-percent increase in the rate of taxation, when combined with the additional gains that would likely be recognized from the more frequent sale of securities as a result of removing the holding period requirement as well as from removal of the ability to offset ordinary income by losses on the sale of securities, would significantly compensate for any anticipated revenue loss from removal of the holding period requirement.

Under this approach, the computation of the tax on any net capital gain would be totally separate from any other tax computations. This is similar to the way corporations are taxed on their capital gains at present. Thus, there would no longer be a tax preference item for the capital gains deduction for purposes of computing the alternative minimum tax. In fact, the whole alternative minimum tax structure could perhaps be eliminated with the elimination of the capital gains deduction preference. Taxpayers would no longer be able to offset their remaining taxable capital gains by itemized deductions and the like. Therefore, to the extent the 60-percent capital gains deduction is the major source of tax preference items under current law, elimination of this ability would virtually eliminate the need for the alternative minimum tax. Elimination of this tax would be a major step forward in the simplification of the tax law.

Finally, for the sake of simplicity, we would make the effective date of any legislation January 1984. We recommend this to avoid the myriad recordkeeping problems encountered with midyear effective dates. It has been our experience that overly complex rules tend to be self-defeating, that is, they create more gaming possibilities than were previously available, since numerous specific rules are read specifically, and they increase the taxpayer's contempt for the arbitrariness of the tax law.

We appreciate this opportunity to present our views to your committee. We recognize that implementing such changes would require a great deal of time, effort, and study. Members of our firm stand ready to assist you in any way possible in your efforts to restructure this very significant and complex area of the tax law.

[The prepared statement follows:]

STATEMENT OF JANICE M. JOHNSON, COORDINATOR, NATIONAL TAX PRACTICE, OPPENHEIM, APPEL, DIXON & CO.

Good morning Mr. Chairman and members of the Committee. My name is Janice M. Johnson and I am here on behalf of our firm, Oppenheim, Appel, Dixon & Co., rather than on behalf of any specific client of the firm. We do, however, represent many taxpayers in the brokerage industry. It is because of the experience we have gained over the years in doing their tax planning, and in preparing their tax returns, that I am here today.

The most effective way to foreclose the gaming currently taking place with respect to capital gains and losses would be to make several substantial changes in the manner in which such gains and losses are taxed. The changes which I am about to suggest would not, however, lessen the incentives for investing in corporate America.

We recommend that the holding period necessary for obtaining long-term capital gain or loss treatment on marketable securities be eliminated. This would result in the taxation of all gains on such securities as long-term, even if the securities were held for only a day. Conversely, any loss on such securities would be long-term immediately.

We would not limit this treatment to marketable securities but, instead, we would have it apply to all instruments that are affiliated with marketable securities, i.e., stock options, options on indexes and the like. Instruments such as regulated futures contracts on silver and other commodities would continue, however, to be taxed under the current scheme, resulting in 60 percent long-term gain or loss and 40 percent short-term.

Treating all securities and securities-related instruments alike would eliminate the tax law's current bias in favor of investment in speculative instruments. For example, an investor in regulated futures contracts can sell those contracts two days after their purchase and have 60 percent of any gain treated as long-term capital gain, while only 40 percent is treated as short-term capital gain. Keep in mind that after holding these contracts for only two days, 60 percent of the investor's gain will be taxed at the preferential long-term capital gains rate of 20 percent, while only 40 percent of his gain will be taxed at up to the maximum Federal tax rate imposed on individuals of 50 percent. On the other hand, if that investor had put his money into the common stock of a fast-growing company, and, after holding that stock for eleven months, he sold it at a large capital gain, the whole gain would be short-term, taxable at a maximum rate of 50 percent.

Furthermore, treating all securities-related instruments similarly for tax purposes would eliminate the confusion that presently exists as to the tax treatment of instruments that are economically similar but apparently taxed differently. Under the current taxing scheme, cash settlement regulated futures contracts, cash settlement index options, and options on cash settlement regulated futures contracts could all be subjected to differing tax treatments.

With the proliferation of these securities-related instruments, special interest industry groups and the like, the tax law is favoring the quick-turn speculator in such instruments rather than the longer-term investor in pure equity instruments. While it is important to encourage the speculator, in order to provide liquidity for the financial markets, it is also important to encourage the longer-term equity investor. Therefore, since each plays an important role in assuring that the capital markets function efficiently, it should not be the tax law's function to arbitrarily favor one over the other. However, this is what occurs when transactions in certain securities or related instruments yield immediate long-term gain, while others yield it only after the instrument is held for a period of time, and still others, because of the limited life of the instruments involved, can never yield long-term gain. Since some securities-related instruments presently being offered seem to cross the traditional line of what is a commodity and what is a security, some instruments will be preferred not on their investment merits alone, but on whether the net after-tax economics favor them. This is inconsistent with the goal of an even-handed taxing system.

For the astute investor, who is receiving sophisticated tax advice, there are, of course, ways to assure that either the gain on the sale of the common stock receives long-term treatment, or that recognition of the gain is postponed until a later year. It does not, however, seem to be a fair taxing policy that leaves these benefits only to those who can pay for the professional advice necessary to secure them.

Furthermore, setting the holding period necessary for receipt of long-term capital gains treatment at an arbitrary length of time of one year, six months, or any other period, totally ignores the economics of the investment. Making the attainment of long-term treatment immediate would allow the investor in securities to move freely in and out of his investments at the point in time when it is economically sound to do so. This would avoid the current arbitrarily lengthened holding periods used to obtain long-term capital gains treatment, as well as the prematurely shortened holding periods used to obtain short-term capital loss treatment.

We would also recommend that capital losses on securities only be useable to offset capital gains on securities. This would eliminate the ability to offset short-term capital gains from the sale of other capital assets (such as land or regulated futures contracts involving silver) by losses from the sale of securities. The ability to offset any ordinary income by capital losses should also be eliminated. There is no logic in the current allowance of a $3,000 capital loss against ordinary income, just as there would be no logic in reducing that allowance to $1,000.

To compensate for the revenue loss that it is feared will result from reducing (and, therefore, presumably also from eliminating) the holding period necessary for achieving long-term capital gains treatment, we recommend that a flat tax at a rate of 25 percent be levied against net capital gains from the disposition of securities. This is a slight increase from the current 20 percent rate of taxation imposed on such gains. It seems likely that this 5 percent increase in the rate of taxation, when combined with the additional gains that would likely be recognized from the more frequent sale of securities as a result of removing the holding period requirement, as well as from removal of the ability to offset ordinary income by losses on the sale of securities, would significantly compensate for any anticipated revenue loss from removal of the holding period requirement.

Under this approach, the computation of the tax on any net capital gains would be totally separate from any other tax computations, similar to corporations. Thus, there would no longer be a tax preference item for the capital gains deduction for purposes of computing the alternative minimum tax. In fact, the whole alternative minimum tax structure could, perhaps, be eliminated with the elimination of the capital gains deduction preference. Taxpayers would no longer be able to offset the 40 percent of long-term capital gains, which, under the current taxing scheme, are still subject to taxation after taking into consideration the 60 percent deduction, by itemized deductions and the like. Therefore, to the extent the 60 percent capital gains deduction is the major source of tax preference items under current law, elimination of this ability would virtually eliminate the need for the alternative minimum tax. Elimination of this tax would be a major step forward in the simplification of the tax law.

Finally, for the sake of simplicity, we would make the effective date of any legislation January 1, 1984 to avoid the myriad recordkeeping problems encountered with mid-year effective dates. It has been our experience that overly-complex rules tend to be self-defeating. That is, they create more gaming possibilities than were previously available, since numerous specific rules are read specifically; and they increase the taxpayer's contempt for the arbitrariness of the tax law.

In light of these concerns, we offer our suggestions as an attempt to vastly simplify the rules for taxing transactions with respect to marketable securities and related instruments (with, we believe, no substantial loss of revenue to the Treasury). We appreciate this opportunity to present our views to your Committee. We recognize that implementing such changes would require a great deal of time, effort and study. Members of our firm stand ready to assist you in any way possible in your efforts to restructure this very significant, and complex, area of the tax law.

Mr. ANTHONY. Thank you very much, Ms. Johnson, for a very thoughtful presentation.

Mr. Thompson.

STATEMENT OF STEVEN C. THOMPSON, CPA, PROFESSOR OF TAXATION, UNIVERSITY OF HOUSTON AT CLEAR LAKE CITY, TEX.

Mr. THOMPSON. Thank you, Mr. Chairman. I have a prepared summary, and respectfully request that you accept my complete statement for the record.

I am Steven G. Thompson, and I address the issue of capital loss carrybacks for the individual. We look for equity in our tax laws, yet what is equitable in the following example? If just before year end a taxpayer is forced to realize a gain, and let us say that gain is $50,000, and he then takes those proceeds and reinvests them, and shortly into the next year he loses his profit, in fact, he is forced to realize his loss, what are his investment consequences?

Well, if the taxpayer was fortunate enough to recover his original investment, he has no economic gain or loss. He simply has what he started with. In other words, he has a profit wash. But from a tax standpoint, even though he recovers his original investment, he loses. Why? Because he includes his realized gains in full and only recognizes his losses up to $3,000 per year, or possibly as little as $1,000 per year, as has been proposed.

Well, in other words, on April 15 of the subsequent year, he must pay tax on the $50,000 gain. More than likely, this will generate a $25,000 tax burden. His only current remedy is a $3,000 per year writeoff for approximately the next 17 years. That just does not sound very equitable.

Well, we must face reality. Situations like this do happen. It happens more than we would like to think. I have seen it as a practitioner. I have had to teach it as a pedagog. And I have experienced it as an investor. So what can we do? What can the committee do to help eliminate this injustice?

Well, perhaps the easiest solution might be to allow for a complete reduction of capital losses for individuals. But a more equitable solution is to add a provision to section 1212(b) that allows a capital loss carryback for individuals. This would be very similar to the 1981 amendment of section 1212(c) that pertains to the regulated futures contracts.

Earlier this morning Mr. Archer asked Mr. Chapoton a question as to whether or not he favored the carryback of losses, and he said he would look into it. He had no response. But he did make a statement saying that he thought that a lot of investors did like the carry forward aspect. Well, I submit that we make this an election, and therefore we aid in the administrative efficiency of this, and we do allow for mitigation of the wrong.

Well, would such a proposal violate any of the long-standing traditions of taxation? The answer is no. Since 1954, Congress has always seen fit to eliminate taxpayer inequities, especially when the injustice is the result of the annual accounting period or even the taxpayer's wherewithal to pay.

Examples where Congress has taken control in the past are common under section 1341 for the restoration of amounts held under the claim of right. We look at capital loss carrybacks for corporations. We have the income averaging provisions. We have the disaster loss election. And we even have special provisions that relate to the taxpayer's wherewithal to pay.

Common examples are like kind exchanges, involuntary conversions, and the sale or exchange of a personal residence. We could even point to section 1244, the loss and small business stock. Here we have a section that generates ordinary deductions for the taxpayer.

On closing, I have one final question, and I guess, getting away from my prepared statement, I have done studies of the 1959 revision or the compendium, tax revision compendium, and I have done studies for it, trying to find out why we have not mitigated this effect, and probably the only possibility was that—the only question I have seen raised in the past is that such a provision might lead to unnecessary risk taking by the investor, in other words, letting him have a carryback.

Well, by its very wording, the proposed amendment could be elective and only used to offset capital gains, keeping in mind the primary purpose of this proposal is to mitigate the effects of the annual accounting period. It is not to generate ordinary deductions. It is ironic when things get rough for the economy, we encourage the investor. So when things get rough for the investor, let us not penalize him. Let us give the small investor the same opportunity we give to the small business person, an incentive without a penalty.

I implore your consideration for the capital loss carryback for individuals, and Mr. Chairman, I thank you for your time.

[The prepared statement follows:]

STATEMENT OF STEVEN C. THOMPSON, CPA, INSTRUCTOR OF TAXATION, UNIVERSITY OF HOUSTON, CLEAR LAKE CITY, TEX.

One of the earliest attempts to identify the criteria for taxation is credited to Adam Smith who, in 1776, suggested "that a good tax ought to be equitable, convenient, certain and economical". He labled this criteria, the "canons of taxation". Yet over two hundred years later, how can these canons be justified in the following example.

A taxpayer purchases $10,000 of stock options traded on the Chicago Board Options Exchange during the summer of 19X2. The expiration date of the options is November of 19X2. When November arrives and the taxpayer's investment has appreciated substantially (FMV-$60,000), he or she is forced to make a decision—either exercise the options or realize a gain of $50,000. Unable to secure sufficient capital to exercise the options, the taxpayer is forced to sell. Because of a desire to continue to invest, a reinvestment is made in similar or even the same options that expire in May of 19X3. Due to market conditions, the value of the options drop so that all the taxpayer is able to salvage by the exercise date is his original investment of $10,000.

Question 1. Has the taxpayer suffered an economic loss?

Answer. From an investment standpoint—No, the taxpayer still has his initial investment of $10,000.

From a tax standpoint—Yes, the taxpayer has suffered a tremendous injustice. Why? Because in his 19X2 individual income tax return he will have to report a $50,000 short term capital gain that in all probability will be taxed at the 50 percent marginal tax bracket costing an additional $25,000 in April of 19X3. Will the taxpayer get an offsetting deduction? Yes, but only to the extent of $3,000 per year if the taxpayer experiences no further capital gains.

Question 2. Is this example a bit fabricated or the product of an author's imagination?

Answer. Sadly enough, No. As a practitioner I've seen it, as a pedagogue I've had to teach it and as an investor I've had to experience it.

Question 3. What can Congress do to eliminate such an injustice?

Answer. A provision can be added to IRC § 1212(b) that is similar to the provision of § 1212(c) pertaining to regulated futures contracts [added by the Economic Recovery Tax Act of 1981]. This new amendment would allow a loss from a security transaction to be carried back to the three preceding tax years at the election of the taxpayer and offset against security gains.

Question 4. Would such a proposed amendment to § 1212(b) violate any of the long standing traditions of taxation?

Answer. No, since the revision of the 1954 code, Congress has always seen fit to eliminate taxpayer inequities. Especially when the injustice is the result of the annual accounting period or even the taxpayers wherewithal to pay. Examples where Congress has taken control in the past include:

A. IRC § 1341—Computation of tax where the taxpayer restores substantial amount held under claim of right.

B. IRC § 1212(a)(1)(A)—Capital loss carrybacks for Corporations.

C. IRC §§ 1301—1305—Income Averaging

D. IRC § 165(h)—Disaster loss election.

E. Many provisions related to the taxpayers wherewithal to pay. §§ 1031, 1033, 1034 to name a few.

F. IRC § 1244—Loss on small business stock.

Question 5. Would a provision as proposed [in Question 3] lead to unnecessary risk taking by the investor?

Answer. I feel that a provision as proposed would only serve as a remedy for the taxpayer that has suffered at the expense of realized gains. By its wording, the amendment would only serve to mitigate the effects of the annual accounting period and not allow an ordinary deduction that may encourage risk taking. I feel that it would only be equitable that one give the small investor the same opportunity that a small business person has in attempting to make an honest profit.

Mr. ANTHONY. Mr. Thompson, I thank you for your contribution to the hearing that we have had today on the issue of Federal tax treatment of capital gains and losses.

I think the record that has been established here with the panels has helped, and will give the committee an opportunity to look at where we have been, where we are, and where we need to go. And I must admit that some of the points that each of you has made today are positions that I personally feel are correct. I personally support a lot of the things that you had in your testimony, Ms. Johnson. We also thank you for your offer of future help as we try to rewrite some of these complicated tax policies.

This brings the hearing to a conclusion, and we will be in recess until the call of the Chair.

[Whereupon, at 2:15 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

EDISON, N.J., *October 31, 1983.*

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: Although I am unable to testify at the hearing scheduled for November 1, 1983, I would like to express my views.

I agree with the general scheme in the taxation of long term capital gains which is to encourage investment in capital assets which will foster the long term economic growth of our nation. However, I believe that relatively short term speculative investments, such as many of those on our nation's securities markets, encourage artificial valuations of our nation's corporations. Obviously, individuals should be free to trade stocks as they desire. However, the tax law should not be used as a carrot to encourage artificial and speculative trading. I believe that a reduction in the long term capital gain holding period will serve only to increase speculative activity and discourage investors from maintaining their investments in potential risky ventures.

The last point is probably more important. Under current law, one who suffers a short term capital loss potentially can reap greater tax savings than one who incurs a long term capital loss. By reducing the long term capital gain loss holding period, we would encourage investors to "bail out" of their more risky ventures sooner in order to ensure short term treatment. This, in my view, can only hurt capital formation.

Reducing the long term capital gain holding period is costly. I see little purpose to it. I would rather see the funds spent to resolve other inequities which I find in the tax laws. For example:

1. One who has a retirement plan through a corporation can benefit from the ten-year averaging rules of lump sum distributions. Under Section 402 of the Internal Revenue Code, however, one who has provided for his retirement through Individual Retirement Plans cannot.

2. The alternative minimum tax allows deductions for contributions and certain interest expenses. However, no deduction is allowed for state income taxes. Such taxes are certainly a non-discretionary expenditure of taxpayers and, accordingly, appear to be logical items to use as a deduction in computing the alternative minimum taxable income.

I would appreciate your forwarding my views to all members of the Committee on Ways and Means. In addition, I would like to know the views of people testifying on the matters being considered. Therefore, I am enclosing a self-addressed label which can be used to mail extra copies of statements which may be available from the November 1st hearings. When the hearings are published, I would appreciate receiving a copy.

Thank you very much for your time and attention to my opinions.

Very truly yours,

E. Martin Davidoff, C.P.A.

Statement of C. Lowell Harriss, Professor Emeritus of Economics, Columbia University[1]

CAPITAL GAINS AND LOSSES: OBSERVATIONS ON PROPOSED CHANGES IN FEDERAL TAXATION

Budget deficits and existing complexities of tax law impede and complicate changes designed to advance the long-run interests of Americans. Many desirable purposes could be served by, in a sense, "giving away the store" in tax reduction. Expensive government—and ours grows more and more expensive—must be paid for somehow.

In the taxation of capital gains and losses, one encounters a conflict between what may appear to be (a) a reasonable standard for measuring the base (income) for supporting collective effort (government) and (b) a desire to avoid discouraging the accumulation and preservation of capital which adds to future income. Worthy objectives conflict.

If government is to be financed largely by taxing people according to income in the sense of receipts, fairness and equity will presumably be served by the use of a more rather than a less comprehensive measure. But the measure must distinguish the source (e.g., capital) from the flow (income) it produces.

THE HOLDING PERIOD

Your Committee knows well that in some circles the depth of feeling in favor of a six-month or shorter period. Effort and skill which succeeded in realizing gains within, say, nine months would have the rewards taxed less heavily than equal dollar rewards for factory or office work, professional services, business management, or the use of capital (interest and dividends).

Such a result—the taxation of net gains obtained within less than a year at lower rates than earnings from work or thrift—does seem less than the epitome of fairness. True, what is "fair" in taxing will be subject to debate. And fairness need not be a dominating consideration. But if the fruits of useful effort on the job are taxed on one basis, is it really fair to tax the fruits of other kinds of effort, e.g., managing capital, less heavily?

The exclusion of part of a gain has quite generally been justified in part as an offset, albeit crude, to the overtaxation which results from lumping the income of several tax periods (years) into a single unit and subjecting the total—accruals over two years or more—to graduated tax rates. Fairness by reasonable standards does require recognition of the realities of rate graduation. However, when the holding period is less than a year, does not this reason for excluding some of the gains disappear?

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[1] Also Executive Director, Academy of Political Science; Economic Consultant, Tax Foundation, Inc.; Associate, Lincoln Institute of Land Policy. Views expressed are those of the witness and not necessarily those of any organization with which he is associated.

Inflation provides another argument for taxing some gains less heavily than wages, interest, and other income. In a year of very rapid inflation, this consideration has some validity. But how much tax recognition would be appropriate on this score—within a year, remember—for probable inflation in our future?

Fairness, however defined, is not, of course, the only criterion for tax policy. Economic effects are also important. And reducing tax influences on the sale and purchase of assets would seem to contribute to better markets for the allocation of capital. On this score a shorter period is better than a longer. Tax-created discontinuities must reduce the efficiency of markets. "Lock-in" for only a few months can impose burdens. We have no way to measure the amount of such a cost which results from any one discontinuity. This inevitably unknowable fact creates opportunity for exaggeration on both sides.

If shortening the period would, over the years, reduce the total tax on capital gains—and advocates of the change probably expect such a result—then the burden of the income tax on capital as against consumption will doubtless be somewhat less. A tax on capital, even that "accumulated" in a few months, does bear upon personal and financial wealth even though the burden on real resources seems remote. My purely personal inclination would tend to support this result as probably outweighing the fairness aspect noted earlier—except. . . . .

Before discussing the exception, an alternative which seems to have higher claim to actions that would appear to cost revenue, let me accept your invitation to comment on a suggestion that the maximum of $33,000 deduction of net capital losses from other income be reduced to $1,000 a year. If a taxpayer has a net capital loss, do not considerations of equity and economic effects call for treatment parallel to that for the treatment of gains? So it would seem. A major difficult arises, however, from the necessity of relying upon the realization rule. Only gains and losses which are realized are taken into account by tax law. And the owner of property can control realization. Holding until death will permit permanent escape of gain from income taxation. (And estate taxes become less and less of a reality for more and more families.)

The property owner has power to control realization. This fact (in a land whose governments need large revenues) provides a persuasive reason for caution in the allowance of deduction of loss against other income. (Realize losses, hold on to gains, and the Treasury fails to get dollars to pay its bills.) Long ago the $1,000 a year seemed unduly low, So, today, is the $3,000 it would appear. But no clear standard can be cited for setting the one amount as against another.

Wide differences among personal situations assure the existence of cases to illustrate any condition one wishes. Some persons clearly have losses which by reasonable standards are negative income. Again citing standards of reason, deduction of more than $3,000 would be appropriate. If there is to be a change in the loss deduction, some increase would seem to me preferable to a reduction.

Especially because of inflation!

NEED TO RECOGNIZE THE EFFECTS OF INFLATION

Some explicit recognition for the loss of value of the dollar is necessary to get a proper measure of income (on the assumption that realized changes in capital are to be taxed as income along with wages, interest, dividends, and so on).[2]

The failure to recognize inflation in computing taxes bears more heavily upon suppliers of capital than most Americans probably realize. Investors have financed some of the growth of the government sector (and transfer payments) because governments, though pretending to take only part of the fruit (income), in fact demand some of the tree itself (capital). They tax capital as if it were income. The victimizing the investor grew up gradually, in a hit-or-miss pattern as inflation continued.

Inflation can lead to negative real income. For many years, in fact, savings accounts and many bonds lost more in purchasing power than the interest (plus any dollar appreciation). Yet the money yield has been subject to personal income taxes. The shareholder's treatment (full taxation of dividends) is less easily described because capital values change rather considerably. There has often been tax on dividends and realized gain but no real income.

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[2] Capital recovery provisions now free businesses from gross inadequacy of depreciation deductions in computing tax.

The issue is not new. Sixty years ago a leading writer on the subject, Prof. Robert M. Haig of Columbia University, explicitly recognized the point. And his words are of special significance because he, along with Prof. Simons, is usually cited as the authority on the principle of defining "income" for purposes of taxation.

"If income is defined as the total accretion in one's economic strength between two points of time, as valued in terms of money, it is clear that his income will reflect every change in the value of money between those two points of time in so far as the items entered on the balance sheets at those times affect the computation. If the level of prices goes up ten per cent, the money value of my assets will ordinarily follow at like rate. The particular increase in value does not really indicate an increase in my economic strength. My power to command economic goods and services has not increased, for the money-value of these goods and services has likewise increased. So long as we have a money standard which varies, we shall find that even a perfect accounting system will show a net income which is not identical with the true accretion of economic power. Indeed, the more perfect the valuation and the accounting, the greater will this injustice be.

"A man who sold an asset in 1920 which he had purchased in 1914, making an apparent profit of 100 per cent and receiving his pay in fifty-cent dollars is, under our statute, subject to tax on his gain, although that gain is only apparent and not real. . . .

"If it were possible to modify the concept of taxable income so as to eliminate this variation, it would certainly be desirable to do so. . . . But an approximate solution might be realized if we were able to evolve a satisfactory index of the level of prices. . . ."[3]

Exclusion of 60 percent of a realized gain and loss does obviously allow for a good deal of "something"—e.g., inflation and the taxation at the corporate level of earnings on equity captial. But at best the adjustment is crude. No testimony such as this can permit responsible treatment of complex issues. In any case, however, moves for more explicit and refined recognition of inflation do deserve attention.

CONVERSION OF (OTHER FORMS OF) INCOME INTO CAPITAL GAINS

If accretion of benefit—"income" broadly defined—in one form (capital gain) is taxed less heavily than other benefits (wages, interest, etc.), we know what to expect. Ways will be devised to convert other forms of benefit into capital gains. Laws will be adapted to accommodate the process. Complexity grows. Examples are familiar to all of us. And none of us can be familiar with more than a portion of the devices used—or of the various effects. One result, however, must be a considerable cost to the economy. Skills produce less for human benefit than they might. Capital is not so well allocated as it might be. And so on. "Excess burden" of taxation warrants explicit attention in efforts to make for a better world.

Statement of Industry Council for Tangible Assets

I. INTRODUCTION

This statement has been prepared by the Industry Council for Tangible Assets, an association whose members are engaged in the manufacture, importation, distribution, and sale of tangible assets and related business services. It is submitted in response to the Committee's announcement of hearings on the federal tax treatment of capital gains and losses and in lieu of a personal appearance at the hearings that were held on November 2, 1983.

Proponents of efforts to increase federal tax revenues have on several recent occasions proposed an amendment to the Internal Revenue Code that would deny capital gains treatment, and thus would tax as the equivalent of ordinary income, any gain realized on the sale of an asset classified as "non-productive." Such a change in the tax law would have a dramatic impact on the willingness of individuals to buy and hold the myriad kinds of goods whose tax treatment would be negatively affected by the proposed amendment. It can be anticipated that entire industries devoted to the manufacture, distribution, and sale of one or more tangible assets would literally disappear or suffer severe disclocation. As a side effect of the proposed change, the contribution of such property to charitable and educational organizations may also be materially reduced. Because such a change in the tax law would materially affect the financial well-being and behavior of millions of individuals, as well as the fortunes of many thousands of business firms and charitable institutions, it is important that the purpose and rationale in support of the proposal be carefully scrutinized.

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[3] Robert Murray Haig, "The Concept of Income—Economic and Legal Aspects," reprinted in *Readings in the Economics of Taxation*, ed. by R. A. Musgrave and C. S. Shoup for the American Economic Association (Homewood: R. D. Irwin, Inc.: 1959), pp. 67-8.

This paper concludes that no legitimate interest of the federal government in raising revenues or in directing personal investments into favored and allegedly more "productive" forms can possibly be served by this extraordinary and unwarranted proposal. The proposed amendment would turn on its head sixty years' of uncontroversial tax policy, apparently to give vent to the hostility of some toward certain kinds of investment and acquisitive activity. Our reasons for these conclusions are set forth in the following sections of the paper.

II. DESCRIPTION OF THE PROPOSAL TO DENY CAPITAL GAINS TREATMENT TO TANGIBLE ASSETS

When a private investor sells an item of personal property for more than its cost, the resulting gain is treated as "capital gain" for tax purposes. Under present tax law only 40 percent of such gain is included in taxable income, so long as the seller has owned the property for at least one year. Since there is a maximum tax rate of 50 percent applicable to all income, the result is that the highest possible rate of tax on such "long-term" capital gain is now 20 percent, and in many cases the actual rate of tax is much less. The present tax treatment of gain on the sale of items of tangible personal property held for investment or other non-business purposes is essentially the same as that for any other investment—e.g., stocks, bonds, real estate, mutual fund shares, etc.

In early 1981 a bill was introduced in Congress by Representative Shannon and others (H.R. 1821, 97th Cong., 1st Sess.) that would change the capital gains deduction by limiting the availability of that deduction to gains realized upon the sale of "productive assets." The bill was not acted upon during the 97th Congress, but the proposal itself was reiterated in several prominent compilations of possible revenue-raising measures assembled during 1982 and 1983 for the use of members of Congress. The proposal was described as follows in a report prepared in July 1982 by the staffs of the House Ways and Means Committee and the Joint Committee on Taxation: [1]

"The alternative tax for corporate capital gains and the 60-percent deduction for noncorporate capital gains could be allowed only for gains on "productive" assets. Productive assests could be defined as stocks, bonds, property used in a trade or business, and real property used by the taxpayer for residential purposes or rented to others. Under this proposal, real property used for farming purposes would not be defined as a productive asset unless, during the year before the sale or exchange, the taxpayer materially participated in the operation of the property, and the taxpayer or tennant engaged in substantial farming activities on the property. Also, corporate stock would not be a productive asset if at any time during the two years before sale or exchange more than 20 percent of the corporation's assets consisted of assets other than cash, productive assets, inventory, and accounts receivable."

This description tracks the terms of the Shannon bill, H.R. 1821, although it neglects to mention that provision of the Shannon bill which would treat timber, coal and iron ore as "non-productive.[2] In March 1983 the Democratic Study Group (DSG), comprised of a substantial percentage of the Democratic members of the House of Representatives, published a list of possible revenue-raising proposals and included in it the following: [3]

"*Eliminate Capital Gains for Non-Productive Assets:* Current law makes no distinction between productive and non-productive investments. Thus, all investment income from the sale of assets is given capital gains treatment. This proposal would restrict the lower capital gains tax rate to productive investments, disallowing such treatment for assets such as antique cars, gold, coins, and art."

In a letter to President Reagan dated October 11, 1983, Rep. Matthew McHugh, Chairman of the DSG, reported that in a recent survey of House Democratic members as many as 82 percent of the 40 percent of House Democrats who responded to the survey could be considered as favoring elimination of the capital gains preference for "non-productive assets (e.g., coins art)".

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[1] Staff of the Joint Committee on Taxation 97th Cong., 2d Sess., Description of Possible Options to Increase Revenues 166 (Comm. Print 1982).

[2] The Shannon bill provides that "property used in a trade or business," as defined by Code Section 1231(b), would be considered "productive," "except that such term does not include property referred to in paragraph (2) of Section 1231(b)." Section 1231(b)(2) refers to timber, coal and iron ore.

[3] Democratic Study Group Special Report No 98-6, "Revenue Options for fiscal year 1984," March 21, 1983 at p. 5.

To this point H.R. 1821 introduced in 1982 represents the only expression of the proposal in specific legislative form of which we have knowledge. Thus, an examination of that bill is appropriate to indicate the precise intent of the proponents of the proposal. Under that bill the deduction of 60 percent of net capital gains for individuals, and the lower 28 percent rate of tax for corporations, would be allowed in any year for the lesser of net capital gain as determined under exisiting law or such gain determined by only taking into account sales of "productive assets." The term "productive asset" is defined to include any share of stock in a corporation, any bond or other evidence of indebtedness, property used in a business, and real estate used by the taxpayer as a residence or rented by the taxpayer to others for residential or business use, but generally not for farm use. The result would be that gains from the sale of any form of non-business tangible asset or from vacant real estate would be taxed at ordinary income rates except to the extent that the taxpayer could offset such gain with losses from the sale of other capital assets. In cases in which the taxpayer had net gain, taking into account all captial gains and losses, the net gain would first be attributed to non-productive assets in determining the allowable capital gains deduction.[4]

Net short-term gains (realized where assets are held less than one year prior to sale) and net losses of either type would not be affected by the change. All net short-terms gains would continue to be taxed at ordinary income rates (as under present law) and net long-term losses from the sale of non-productive assets could only be deducted to the extent of any long-term or short-terms capital gain (plus $3,000 of ordinary income on 2-to-1 basis, as under present law). Further, as under present law, if property cannot qualify as having been held for investment rather than for personal use, a deduction for capital losses would not be allowed. In sum, so-called "non-productive assets" would be accorded the least favorable treatment on the gain side (taxed as ordinary income if not offset by other capital losses) and the least favorable treatment on the loss side (not deductible except in some cases to reduce other capital gains plus up to $3,000 of ordinary income).

The extraordinary negative asymmetry noted above is without precedent in the Internal Revenue Code. In regard to sales of property used in a business, Congress has provided for the most favorable treatment of gains on the one hand and the most favorable treatment of losses on the other, and it has done the same in connection with investments in small operating businesses,[5] but in no instance has Congress done the reverse and imposed ordinary income treatment on the net gain side but non-deductible or capital loss treatment on the loss side. The pending proposal as set forth in H.R. 1821 and as described in recent compilations accomplishes that harsh result for "non-productive assets."

Although the matter is not entirely clear from the language of H.R. 1821, the proposal could well have the effect of eliminating a significant tax benefit now available upon the contribution of so-called "non-productive assets" to charitable organizations where the assets have appreciated in value in the hands of the donor. Under present tax law the value of contributed property for purposes of the charitable deduction is reduced by any gain which would not have been long-term capital gain if the property had been sold by the taxpayer instead of given away.[6] The IRS applies this rule by reference to whether gains would be "recognized" as other than long-term capital gains.[7] Since the only effect of the proposed legislative change would be to "recognize" gains on the sale of "non-productive" assets as other than long-term gain, that circumstance could logical support a conclusion that such gain is not long-term gain for purposes of the charitable contribution deduction, and therefore cannot figure in the determination of the amount of the charitable deduction in the event of a gift of such property to a charitable organization.[8] In that event, for example, a taxpayer who bought an artwork for $10,000 and years later contributed it to a museum when its value was $50,000 could only deduct $10,000, not the full $50,000 as under present law.

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[4] For example, if a taxpayer realizes a gain of $1,000 on stock, a gain of $1,000 on gold, and a loss of $1,000 on rental real estate, his net gain of $1,000 ($2,000–$1,000) would be entirely attributed to the gold transaction, and under H.R. 1821 no capital gain deduction would be allowed.

[5] See IRC § 1231(a) and 1244.

[6] IRC § 170(e)(1)(A).

[7] Treasury Regulations § 1.170A–4(a)(1).

[8] At least one commentator on this proposal has concluded that it would eliminate the "market-value" deduction for collectibles donated to charitable institutions. R.S. McIntyre & D.C. Tipps, Inequity and Decline 106 (Center on Budget and Policy Priorities 1983).

III. LONG-STANDING WAYS AND MEANS COMMITTEE JUSTIFICATION FOR CAPITAL GAINS DEDUCTION REMAINS VALID AND APPLIES TO ALL FORMS OF TANGIBLE ASSETS

The first full-scale federal income tax was enacted in 1918, and under its provisions the entire gain from the sale of a capital asset was fully included in income, while any loss from such a sale was fully deductible.[9] By enactments in 1921 and 1924, respectively, Congress introduced a separate and much lower rate of tax on capital gains, and then limited the deduction for capital losses essentially to the amount of the taxpayer's capital gains.[10] The relevant Ways and Means Committee report in 1921 contains the following pertinent explanation for adoption of a separate and lower tax on capital gains:[11]

"The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the years in which the profit is realized. Many such sales, with their possible profit taking and consequent increase in tax revenue, have been blocked by this feature of present law."

Again, in 1923, the rationale was reiterated by the Ways and Means Committee at greater length:[12]

"[The previous system] involved an injustice to the taxpayer, in that an increment frequently accumulated over a period of many years was taxed at a high surtax rate because the property was converted into cash in a given year and the net profit arbitrarily attributed to the year in which the sale took place. But of much greater importance was the decided interference with the normal course of business and commerce. With a maximum tax of 77 per cent there was a severe artificial restraint on sales at a profit, and many transfers of property extremely desirable from the standpoint of economic development and general public welfare were not only retarded but actually prevented." [13]

The principle that net gain on the sale of capital assets should be distinguished from other forms of income, and taxed at lesser rates, has remained a foundation stone of the federal tax law since 1921. No Congress and no political administration has altered that principle. Controversy persists over what transactions should be treated as giving rise to ordinary income or loss as distinguished from capital gains, but that controversy focuses on the status of the taxpayer and in connection with assets held in a trade or business—addressing such categories as inventory, depreciable equipment, futures contracts or whatever. The personal or investment holdings of taxpayers have always been treated as capital in nature almost from the inception of the income tax.

Over the years, of course, the capital gains provisions have been amended and modified in regard to such matters as the amount of the capital gains deduction or lower rate of tax, the holding period required to qualify for the deduction or lower rate, separate provisions for corporations as distinguished from individuals, and "recapture" as ordinary income of a portion of capital gain measured by depreciation previously taken on the property sold.[14] None of these changes or modifications suggest or imply any retraction of the principle first recognized by Congress in 1921 that gain on the sale of a capital asset should not be treated as the equivalent of periodic income from wages, dividends, interest, or the like. Indeed, Congressional consideration of proposed changes in the capital gains tax structure routinely analyze the proposed changes in terms of those long-recognized justifications for treating capital gains differently.[15]

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[9] Revenue Act of 1918, Pub. L. No. 254, §§212-14, 65th Cong., 3d Sess., 40 Stat. 1064-69.

[10] Revenue Act of 1921, Pub. L. No. 98, §§206, 214, 67th Cong., 1st Sess., 42 Stat. 232-33, 239-42; Revenue Act of 1924, Pub. L. No. 176, §§208, 214, 68th Cong., 1st Sess., 43 Stat. 262-63, 269-71.

[11] H. Rep. No. 350, 67th Cong., 1st Sess. 10-11 (1921), reprinted in 1939-1 C.B. 168, 176.

[12] H. Rep. No. 1388, 67th Cong., 4th Sess. (1923).

[13] The maximum tax of 77 percent referred to by the Committee had been in effect during the first world war. But the rationale given by the Committee for treating capital gains differently was not dependent on that rate. In 1923, the maximum rate was 58 percent and in 1924, it was 46 percent. Revenue Act of 1921, §§ 210 & 211, 42 Stat. 233-37; Revenue Act of 1924, §§ 210 & 211, 43 Stat. 264-67.

[14] See generally Bittker, Federal Taxation of Income, Estates and Gifts, Chs. 50-55 (1981).

[15] This is illustrated most recently by a Joint Committee on Taxation analysis of capital gains issues considered at the November 2, 1983 Hearing before the House Ways and Means Committee, in which a proposal to shorten the holding period from 1 year to 6 months was evaluated in terms of the "bunching," "lock-in" and other distorting effects. BNA Daily Tax Report, No. 213 (November 2, 1983) at p. J-28.

Historically, then, the tax law has differentiated between gains on capital assets and other forms of income for two time-tested reasons. First, such gain represents an accretion in value over time typically extending well beyond one year, such that taxation of the gain in one year at ordinary progressive rates fails to take into account the fact that the gain is not fairly attributable to events occurring only in that year.[16] Second, a failure to accommodate the distorting effect of taxing the entire gain in one year as ordinary income will cause taxpayers, for tax reasons alone, to avoid transactions that otherwise enhance economic development and the public good.[17]

Those reasons for imposing a lesser rate of tax on capital gains apply to tangible assets held either for personal use or personal investment with the same force as in the case of investments in securities or rental real estate. The same unfairness results when the entire gain on the sale of a valuable family heirloom that has appreciated in value over many years is taxed in a single year at progressive rates as when several years' appreciation in the value of a share of publicly traded common stock is taxed in one year. In either case the gain represents value actually accrued over time, and that value is not fairly or realistically ascribable in its entirety to the year of sale. Attribution of the gain only to the year of sale subjects the gain to higher progressive tax rates than would apply were the gain attributed to the actual years in which it accrued. The chosen Congressional solution—and there is more than one way to cure this possible unfairness—has been to continue to tax capital gain in the year of sale, but to impose a lower rate of tax on capital gains compared to other income. Denial of the ameliorating effect of this lower rate of tax in the case of certain assets, but not others, will to that extent resurrect the unfairness and artificiality that caused Congress to introduce the lower rate to begin with.

Further, withdrawal of capital gains treatment for tangible assets will surely have the effect of distorting economic development and trade in all the markets touched by transactions in tangibles. Under the present tax rate structure elimination of the capital gains deduction will increase the tax borne on those capital transactions by 150 percent. That is so severe and increase that taxpayers are certain to respond by postponing or altering transactions in which they would otherwise engage. Many owners of the assets affected may simply choose not to sell those assets except in the event of an emergency, rather than to incur unnecessarily an exhorbitant tax on sale. The degree of such economic distortion is difficult to quantify, but the pervasiveness of the distorting effect cannot fairly be disputed. Yet to the extent that the current proposal is designed to raise revenue, the "lock-in" effect just described will squarely defeat that expectation.[17a]

IV. IDENTIFICATION BY JOINT COMMITTEE ON TAXATION OF CONSTITUTIONAL LIMITATIONS ON CONFISCATORY TAXATION OF CAPITAL GAIN AT ORDINARY RATES

In an inflationary economy, to which we have been bound for many years, a third inportant justification for preferential treatment of capital gains comes into play. The income tax is imposed on income and gain measured in current U.S. dollars and is payable in current dollars. Gain or loss on the sale of an asset generally is measured by the difference between the proceeds realized on the sale and the taxpayer's historic cost in the asset. Cost for this purpose must be expressed in terms of dollars, usually the amount of dollars expended for the asset at the time of acquisition. The tax law does not take into account the declining purchasing power of the paper dollar. It gives no recognition to the fact that in many instances most or all of a taxable "gain" on the sale of an asset is no real gain at all, but rather is a reflection only of the increase in the number of dollars needed simply to identify the original value of the asset. It often is the case that substantial nominal-dollar gain arises for tax purposes where the amount realized from the sale of an asset, once adjusted for inflation, is less in dollars than the cost of the asset. In that event the "gain" is a political declaration, not an economic fact, and to repeatedly tax such "gain" is to consume the Nation's real capital stock.

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[16] *Id.* at pp. 3-60 to 61.

[17] *Id.* at pp. 3-60 to 63.

[17a] The class of "non-productive" assets delineated in H.R. 1821 includes unused farmland and unused real estate generally, including timber lands. In this area the "lock-in" effect caused by the ordinary income treatment of any gain on sales can introduce market distortions and impediments in those specific markets that Congress is highly unlikely to consider desirable. Timber land and farmland alike may remain unused for periods of years to allow for forest growth, resuscitation of soil fertility, or in response to specific governmental programs designed to control total farm production. The terms of H.R. 1821 would severely penalize conservation programs of this sort.

From time to time Congress has reluctantly recognized this circumstance and lowered the rate of tax on capital gains. In 1978 it increased the capital gains deduction from 50 percent to 60 percent of the gain, and in 1981 it reduced the maximum tax on income from 70 percent to 50 percent, thus ensuring a tax no greater than 20 percent on the net capital gain of individuals. In each case it did so after acknowledging that persistent price inflation distorts the real value of assets and that an income tax system laying claim to even a modicum of fairness has to accommodate the effect of price inflation on the paper dollar value of assets.[18]

In 1981, Congress tried further to compensate for inflation by amending the Internal Revenue Code to index the income tax rate schedule, and adjust other fixed dollar exclusions and ceilings.[19] But this indexing is not due to go into effect until 1985, and there are a number of proposals to further repeal or delay such indexing as a revenue raising device.[20] Even if indexing of the rate schedules remains in place, it will not cure the confiscatory impact of taxing some capital gains at ordinary rates. Such gains embody the effects of inflation over the whole period of the investment. In order even to attempt to compensate for the effects of inflation on capital gains by indexing, the cost or "basis" of capital assets would need to be adjusted upward by the rate of inflation from the date of purchase until the date of sale.[21] Indexing of basis itself could likely prove a less than adequate device to achieve equitable treatment of capital gains, since the rate of inflation varies among segments of the economy and inflation has varying effects on different kinds of investments.[22] For this and other reasons relating to obvious complexity, no present provision of the Code provides an indexing adjustment to the basis of capital assets, and none is likely to prove satisfactory in the future.

The preferential tax treatment of capital gains therefore remains the only mechanism in the tax code for ameliorating the effect of inflation on capital gains. In this context, elimination of capital gains treatment when property is sold would greatly exacerbate the effect of taxing fictional gain. The result in some instances would be so severe that the Government would effectively be confiscating a substantial, or even principal, portion of the original value of the property.

The confiscatory effect of ordinary treatment of capital gains in an inflationary economy has constitutional implications. The Constitution prohibits Congress from levying "direct" taxes "unless in Proportion to the Census.[23] So as to leave no doubt, the Constitution also provides that "Representatives and direct Taxes shall be apportioned among the several States . . . according to their respective Numbers. . . .[24] What constitutes a "direct tax" within the meaning of these Constitutional prohibitions has been the subject of dispute and conjecture. Nonetheless, at least since 1895 the Supreme Court has held—substantially in reliance on the views propounded by Alexander Hamilton—that "direct" taxes include head taxes, poll taxes, taxes on land and buildings, and "[g]eneral assessments, whether on the whole property of individuals, or on their whole real or personal estate; . . . .[25] In *Pollock* the Court concluded that a federal income tax that was not apportioned was unconstitutional. It took a constitutional amendment—the Sixteenth Amendment, ratified in 1913—to permit Congress to adopt an income tax such as we now have.

The Sixteenth Amendment, however, does not authorize Congress to levy direct taxes generally without apportionment. It provides only that "Congress shall have the power to lay and collect taxes on *incomes*, from whatever source derived, without apportionment. . . ." (emphasis added). As the Supreme Court observed shortly after the Amendment was adopted, "[a] proper regard for its genesis, as well as its very clear language, requires . . . that this Amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an appointment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overriden by Congress or disregarded by the courts.[26] Direct taxes on capital assets, as opposed to the income earned on those assets, therefore continue to be subject to the constitutional prohibition.

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[18] S. Rep. 1263, 95th Cong., 2d. Sess. 192, reprinted in 1978 U.S. Code Cong. & Ad. News 6761, 6955; Staff of the Joint Committee on Taxation, 97th Cong., 1st. Sess., General Explanation of the Economic Recovery Tax Act of 1981 18–19 (Comm. Print 1981).

[19] IRC § 1(f); see General Explanation of the Economic Recovery Tax Act of 1981, *supra*, at 38–40.

[20] Staff of the Joint Committee on Taxation, 97th Cong., 2d Sess., Description of Possible Options to Increase Revenues 137 (Comm. Print 1982).

[21] Staff and the Joint Committee on Taxation, 95th Cong., 1st Sess., Tax Policy and Capital Formation 27 (Comm. Print. 1977); Staff of the Joint Committee on Taxation, 95th Cong., 2d Sess., Adjusting the Income, Estate and Gift Taxes for Inflation 6–9 (Comm. Print 1978).

[22] *Id;* Tax Policy and Capital Formation *supra*, at 27.

[23] U.S. Constitution Art. I, Sec. 9, Cl.4.

[24] *Id.* Art. I, Sec. 2, Cl.3.

[25] *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U.S. 601, 625 (1895).

Yet a tax on the proceeds of the sale of capital assets that does not take into account the effects of inflation is, in practice just such an unconstitutional direct tax. Indeed, the congressional Joint Committee on Taxation acknowledged as much in a 1977 Report: [27]

"The Constitution forbids imposition of direct taxes by the Federal Government unless the proceeds are apportioned among the States on the basis of population, and the Sixteenth Amendment was needed specifically to exempt the individual income tax from this prohibition. It would be unconstitutional for the Federal Government to adopt a wealth tax, yet much the same result is achieved by defining income from capital in a manner that does not take account of inflation."

Significantly, these telling observations by the congressional committee were made in the context of the existing preferential treatment of capital gains, in support of a proposal to index the tax base on capital investments to neutralize still further the adverse effect of inflation. But obviously if even the existing captial gains tax is constitutionally objectionable in an inflationary economy as a direct tax on wealth, any elimination of the preferential capital gains treatment for a particular class of capital—such as tangible assets—would be even more so.[28]

In another respect denial of relief for capital gains form the full effect of progressive rates of income tax may conflict with Constitutional requirements. The only kind of direct tax which Congress may levy without apportionment is a tax on income. A tax on income must conform to the characteristics inherent in that kind of tax as distinguished from sales, property, estate and gift, or other kinds of taxes. A principal characteristic of an income tax is that the income to which the tax applies is earned over a specified period of time.[29] There may be various reasons for the initial choice of the time period for measuring income, but once the choice is made, it is an integral part of the concept of income upon which an income tax system is based. The period of time upon which the federal income tax is based, of course, is that of one year. The progressive rate structure, for instance, is designed to tax at progressively higher rates those who earn relatively greater income in any given year; and taxpayers file and pay income tax yearly. But Congress has departed from this underlying concept of a yearly income tax in its treatment of income from capital. Income in the form of appreciation in the value of a capital asset that has actually been earned over many years is taxed wholly in the year of the sale. Since this "bunching" of income from capital in the year of sale is fundamentally inconsistent with the time period upon which the rest of the tax code—particularly the progressive rate structure—is based, it is consistent with the concept of income earned in a specified period. Thus it is fair to suggest that on this ground as well the capital gains deduction—insofar as it alleviates the effect of "bunching" gain accumulated by a taxpayer over many years—is constitutionally required unless some alternative form of relief for capital gains is provided.

The present capital gains deduction is not precisely designed to cure the distortions resulting from taxing gain on the sale of property only in the year when a sale or exchange occurs. Nonetheless, in its present form the capital gains deduction represents a substantial lessening of tax in the aggregate such that in most individual cases reasonable, if not perfectly refined, justice is achieved. Withdrawal of this generalized relief in the case of any particular class of assets, such as so-called "non-productive" assets, would present in bold light the issues of egregious distortion of income and possible violation of the Constitution outlined above.

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[26] *Eisner* v. *Macomber*, 252 U.S. 189, 206 (1920).

[27] Staff of the Joint Committee on Taxation, 95th Cong., 1st Sess., Tax Policy and Capital Formation 26 n.7 (Comm. Print 1977).

See also Staff of the Joint Committee on Taxation, 95th Cong., 2d Sess., Adjusting the Income, Estate, and Gift Taxes for Inflation 6 (Comm. Print 1978):

"The net result of the way income is defined under current law is that inflation acts as a personal wealth tax. . . . (A direct wealth tax would be unconstitutional because the Constitution prohibits Federal taxes, except for an income tax, unless . . . proportional to . . . population.)"

[28] Section 408(m) of the Internal Revenue Code, enacted in 1981, singles out tangible assets for especially onerous treatment in connection with the investment of funds in an individually-directed pension plan or individual retirement account, and presents a related constitutional question. This section taxes as ordinary income the portion of any such account that is invested in any one of the specified items of tangible property, including coins, stamps, art objects, and precious metals, at the time the investment is made. This could occur in respect of an increase in value over a longer period of time some of which is attributable to inflation alone, and would apply irrespective of any actual distribution to, or other realization of income by, the individual whose account is involved. Thus, the deferral of taxes until retirement, for which such plans were created, is not available where such investments are made. Arguably, a forbidden direct tax on property is the result, since the usual rules that reduce the effect of ordinary income rates on taxable lump-sum distributions from pension plans would not be available. See IRC § 402(e).

[29] See Bittker, Federal Taxation of Income, Estates and Gifts 3-3 (1981).

In short, in the wake of decades of chronic price inflation, any inclusion of gain measured by a current monetary unit in income subject to tax imposes some degree of direct taxation on property rather than solely on income. If ordinary tax rates are applied to such gains, a substantial tax on property rather than on real income will result. The Congress is prohibited by the Constitution from levying an unapportioned direct tax on property, and would be unjustified in attempting in this way to do indirectly what it is prohibited from doing directly.

V. DURABLE TANGIBLE ASSETS ARE NOT DISTINGUISHABLE FROM OTHER ASSETS ON GROUNDS OF ALLEGED "PRODUCTIVITY"

Proponents of the proposed limitation on capital gains treatment presume to classify assets into categories labeled "productive" and "non-productive." The choice of names is seductive, seeming to relieve the proponents of the need to offer analytical support for the proposal. Government action in favor of "productivity" and in derogation of "non-productivity" needs little defense. The issuse is not simple, however, and the advocates of this precedent-setting and, in our opinion, unwarranted proposal should be called upon to reveal the economic basis for the classifications they offer. We do not believe that convincing theoretical support can be found for the proposed distinction between tangible assets and other kinds of capital assets.

Capital is commonly thought of as one of the independent factors of production, on a par with labor and natural resources. As a result, capital assets are sometimes said to possess a "productive" power or capacity of their own. In that simplistic formulation goods that can be actively combined with labor to produce other goods are distinguished from goods not so actively employed. But when the role of capital is looked at more closely, it is clear that capital is, itself, the product of earlier productions. It is neither fundamental nor inherently "productive." Capital goods derive any "productive" power that they may have from the fact that they represent the more fundamental factors of production—labor, nature, and time—stored up in such a way as to save time and resources in the future.[30] Insofar as capital is "productive" in this sense, most items of durable tangible property share this characteristic. Artwork, gold coins, gold bullion, and antique furniture, just like tractors or computers, are valued because people recognize that they embody and will save in the future the expenditure of time, labor and natural resources.[31] Human creativity, which is embodied in many kinds of tangible assets, is no small part of the value that is "stored up" in all capital goods, including those physically emenable to individual collection. Thus, the concept of "productive capital" properly understood does not provide a theoretical basis for treating items of durable tangible property differently from other kinds of capital goods.

Capital assets are also sometimes referred to as "productive" in an attempt to distinguish them from assets which are thought to have only a "consumption" value. But this cannot be the distinction intended by the current proposal because included among the class of "productive" capital assets is residential real estate.[32] Such property is no more "productive" in the sense suggested than are artworks or precious metals. In fact, the futility of excluding certain capital assets from preferential capital gains treatment merely because they are "consumption" goods has been recognized by Congress at least since 1924. Prior to that time, "property held for the personal use or consumption of the taxpayer or his family" was expressly excluded from the definition of "capital asset." [33] In 1924, that exclusion was eliminated because of a recognition that "a taxpayer selling residential property at a profit" should be permitted "to elect to be taxed under the capital gains section if he so desires." [34]

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[30] See L. von Mises, Human Action 492-93 (3d Rev. Ed. 1966); E. von Bohm-Bawerk, Capital and Interet (Vol. II) 97-101 (1912) (republished 1959).

[31] "For the stock of capital on hand is basically nothing but an aggregate of consumption goods that are in the process of evolving." (footnote omitted) E. von Bohn-Bawerk, *supra* at 96.

[32] H.R. 1821 provides that real property "used by the taxpayer for residential purposes" would be considered a "productive asset." The proposal does not indicate, however, what would constitute a "residential purpose." It is unclear, therefore, whether second homes, or vacation homes which are not the taxpayer's "principal residence" would be considered "productive." If "use for residential purposes" were interpreted in accord with the personal residence "roll-over" provisions, however, such part-time residences would become "non-productive." See IRC § 1034.

[33] Revenue Act of 1921, Pub. L. No. 98 § 206(a)(6), 67th Cong., 1st Sess., 42 Stat. 232-33.

It is important to emphasize that the "consumption" or "use" value of an asset is not in issue in determining whether the asset should be entitled to preferential capital gains treatment. All property is valuable because it can be used by its owners, whether it is a tool, a house, or a "collectible." Insofar as the asset is "consumed" in the sense that it is used up, it cannot be resold at a gain. This is true either of a loaf of bread or a coin that physically disintegrates through use over time. But when an asset is resold at a gain, something besides consumption has occured; the asset at some cost has been preserved by its owner, and economic events have caused others to place a value on it greater than its cost to the seller. This is no less true of items of personal property than of other kinds of capital.

In a related sense, capital assets are sometimes referred to as "productive" insofar as they can be employed to produce new goods. It might be claimed that tangible personal property such as art or gold cannot be so used and so in this sense "non-productive." [35] But in fact such types of property have a particular value which may contribute to future production. Experience has shown that some such assets may be expected to retain an enduring exchange value, notwithstanding fluctuations in the perceived value of other capital assets such as corporate stocks and bonds, or of money itself. Thus, they serve as a mechanism for preserving capital for future use or reinstatement. Another way of describing this productive function of durable tangible property is to recognize that it serves as a substitute for money in some economic contexts. The productive value of money, because of its usefulness as a mechanism of exchange, is almost a self-evident truth in any modern economic system.[36] Significantly, classical discussions of the use of money to facilitate production have usually presupposed that money consists of or is based on some precious metal such as gold, or other durable commodity.[37] It follows that tangible assets which fulfill an economic function similar to that of money are as "productive" as the other assets whose future purchase they make possible.

This capacity of durable tangible assets to preserve capital is more "productive" than many more conventional investments which the proponents of this legislation unquestionably consider "productive." Insofar as a person invests his capital in an enterprise in which it is not, in fact, used "productively," but is instead "used up," the capital is lost to society and can never contribute to further capital formation.[38] This is the result if the investment is in an enterprise that dissipates the capital it has acquired, regardless of whether the investment provides a temporary return to the investor.[39] It is fallacious to suggest that an investment in a precious metal or other tangible asset, which is made precisely because it will preserve capital for future use, is less "productive" than other, perhaps more common forms of investment, any one of which may prove to be wasteful.

A few examples may be usefully noted. An investor may be convinced that a proposed business enterprise will be successful and purchases shares of stock issued by its promoters in the expectation that at a later date he will be able to sell the stock at a gain, or that he will receive periodic payments of dividends that will render his investment valuable. Soon thereafter the enterprise fails, and the investor receives nothing. Nonetheless, he is deemed to have invested in a productive asset under the pending proposal. Or suppose an investor purchases shares in a company that successfully promotes a new product with the result that the value of the stock rise dramatically, but following the investor's sale of which the product is discovered to have caused servere injury to the persons who used it. He too is considered to have invested productively. On the other hand consider the case of a collector of coins who through judicious and insightful selection of items for purchase over time is able to assemble a collection which he sells some years later at a substantial gain over his original cost—because there are persons who at the time of the sale ascribe that appreciated value to his collection. Assume further that the collector then takes the proceeds from the sale of his collection and buys stock in a new manufacturing enterprise then being promoted. Under the pending capital gains proposal he is deemed to have originally invested in a non-productive asset. We submit that no reasonable distinction based on alleged productivity may be made between these hypothetical investors.

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[34] S. Rep. 398, 68th Cong., 1st Sess., reprinted in 1939-1 C.B. 266, 281 (April 12, 1924); Revenue Act of 1924, Pub. L. No. 176, § 208, 68th Cong., 1st Sess., 43 Stat. 262-63.

[35] If this is the distinction contemplated, the Shannon proposal would inexplicably classify several other types of productive property as "non-productive" as well. There can be no doubt, for instance, that real property actively used for farming—that is, for the raising of stock or the cultivating of crops—is "productive" in the sense suggested, but the Shannon bill would consider such property "non-productive" unless the taxpayer "materially participated in the operation of such real property." H.R. 1821. There is no connection between the participation of an investor in the operation of the property which he owns and the "productivity" of that property as an economic matter. Indeed, an analogous requirement for investments in corporate stock would render the vast majority of corporate investments by individuals "non-productive" since investors rarely take an active role in the operation of companies in which they own stock. In fact, the "material participation" requirement, which seems to have been borrowed from the estate tax provisions of the Code (IRC § 2032A(b)(1)(C)(ii)) makes no sense in the context of the capital gains tax. Similarly, the Shannon proposal would classify timber, coal and iron ore as "non-productive." But these raw materials are at least as critical to the process of production as any machine or tool or share in an entity that holds such material.

[36] See e.g. E. von Bohn-Bawerk, Capital and Interest (Vol. II) 70-71 (1912) (republished 1959); Ritter and Silber, Money 11-13 (3d Rev. Ed. 1972).

[37] E.g. Adam Smith, The Wealth of Nations, Bk. I, Ch. 4 *et seq.* (1776); John Stuart Mill, Principles of Political Economy, Bk. III, Ch. 7 (1871).

[38] John Stuart Mill, Principles of Political Economy, Bk. I, Ch. IV, § 3 (1871).

[39] *Id.*

A distinction is also sometimes drawn between various kinds of capital assets on the basis of whether or not they return a periodic stream of income by means of interest or dividends or rent. Certain items of tangible property might be considered "non-productive" on this ground if they do not offer such a periodic return. But here again any distinction between such items and other assets considered by the proponents of this legislation to be "productive" breaks down. The proposed legislation clearly contemplates that corporate stocks, bonds and residential real estate would be considered "productive." But residential real estate produces no stream of rent to it user-owner, and the proposed legislation, while classifying such property as productive, surely would not impute taxable rent to the user-owner. Moreover, some corporate bonds are sold at a discount with no promise of periodic interest and no bond is sold with the assurance that the face amount of the obligation will be paid at maturity. Similarly, many corporate stocks pay no dividends, but would be classified as "productive" nevertheless. One frequently cited commentator on the federal tax law has observed: [60]

"There is no fundamental difference between the yield of a bond or note that is originally issued at a discount . . . and a coupon bond. The difference is at most a matter of the timing of the yield. . . . Investors in corporate shares and real estate act as if the prospect of selling the property for more than they paid for it is as important as dividends or rent in their decisions."

That is, a promised, periodic stream of income is never assured, and often is not the principal reason why an individual investment or acquisition is made. Likely preservation of, or an increase in, the value of an income producing asset will always figure prominently in the choice to acquire the asset. Where that appreciation in fact occurs, the economic result is not distinguishable from the appreciation that results upon the sale at a gain of a tangible asset that during the period of ownership yielded no periodic stream of income.

The pending proposal, and all attacks on so-called "collectibles," assume that certain items of tangible property possess identifiable "productive" characteristics, while others do not. They also assume that any investment in a corporation (other than one that predominantly holds tangible property) is by its nature "productive." Each of these presuppositions is fallacious. No item of machinery by itself is productive. A typewriter or a lathe is as inanimate as a bar of gold. Each becomes "productive" only when employed in combination with other factors of production—time, labor, and other property. There is no economic theory to support a conclusion that individual or collective investments in—for example—lathes is more likely to enhance national productivity than are individual investments in precious metals. Machinery can be built for mistaken reasons and result in unfulfilled ends. Machinery can depreciate and never earn a return for society or individual investors. It all depends on the wisdom and foresight of the individuals involved. Similarly, investments in corporate shares may imply no ownership of "productive" property at all, but only efforts of individuals to provide services for fees. Examples are consulting firms, research organizations, and many professional corporations. Funds invested in such entities—classified "productive"—are principally, and sometimes exclusively, employed to pay the current salaries of the service providers. The capital investment may be immediately exhausted ("consumed") by the service providers. No economic theory would support a view that such a sequence is inherently more "productive" than the collection and storing of precious metals or any other tangible assets that in fact retain their value or appreciate in value overtime.

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[60] Richard Goode, The Individual Income Tax 181 (Brookings Institution 1976).

In short none of the foregoing methods of ascribing "productive" characteristics to certain of assets provides a convincing ground for concluding that items of tangible personal property that may be sold at a gain are less "productive" or less "socially useful" than the stocks, bonds, and other types of property for which favorable capital gains treatment would continue under the pending proposal.

VI. ANY ATTEMPT TO DISTINGUISH "PRODUCTIVE" FROM "NONPRODUCTIVE" ASSETS IN THE TAX LAW WILL GENERATE EXTRAORDINARY ADMINISTRATIVE COMPLEXITY

There is nothing simple about the deceptively facile classification of property into "productive" and "non-productive" categories. The administrative morass that will result from an enactment of the sort proposed in H.R. 1821 is suggested by a provision in that bill which would treat as "non-productive" stock in a corporation if any time in a 2-year period prior to sale more than 20% of the value of the corporation's property consisted of "non-productive" assets. This extraordinary provision would require every corporation and every shareholder to know on a daily basis the precise current market value of all the property held by the corporation in order to anticipate the tax effect of any sale of shares in the corporation. The already excessive complex corporate reorganization, liquidation, and redemption provisions of the Code would be rendered totally unmanageable by an enactment of this sort.[41]

Inevitably, where ownership of shares in a corporation yield a tax result more favorable than ownership of assets of property, taxpayers and their advisors develop the appropriate corporate vehicles. Congress responds in the name of revenue protection and equity among taxpayers by enactment of Code provisions that treat transactions in stock or transactions by corporations as if the shareholders had concluded the transactions directly. Statutory examples include the accumulated earnings tax (IRC §§ 531-537), the personal holding company rules (IRC §§ 541-547), the foreign personal holding company rules (IRC §§ 551-558), the provisions that govern foreign investment in real property in the United States (IRC § 897), and the collapsible corporation rules (IRC § 341). Apart from whether these statutory responses accomplish their goals, they plainly introduce substantial complexity in planning many routine business transactions. A statutory attempt to isolate a corporation's "non-productive" assets from its other assets would be so pervasive an imposition that it would likely not be possible fully to anticipate the fundamental ways in which otherwise useful corporate transactions would be impeded by the presence of the rule.

VII. POLITICAL JUDGMENTS REGARDING PRODUCTIVE USES SHOULD NOT DISPLACE PRIVATE JUDGMENTS

The conclusion is inescapable that the proposed legislation does no more than implement a political, rather than an economic, judgment concerning what kinds of investments are most "useful" for society. But any political determination as to which investments are deemed to be productive "would be subjective and could result in administrative difficulties as well as undesirable distortions in capital markets." [42] As one respected economist has pointed out, the political distinction between "productive" and "nonproductive" investments presupposes that it is possible for a system of central planning to second-guess and improve on the market mechanism.[43] But he further observes: "Only to acting that would be purposeful in the plans of such a system's manager are positive value and the epithet productive attached. All other activities performed in the market economy are called non-productive in site of the fact that they may be profitable to those who perform them." [44]

We submit that the presupposition that central planning is superior to the market mechanism as a vehicle for allocating resources is fundamentally flawed. There is no technique by which to compare an object's comparative usefulness to different people, for no two people are alike in all their preferences.[45] The relative prices of things arrived at in unhampered markets do, however, reflect the rank orderings of sovereign members of society.[46] As a result, the market approximates an efficient allocation of resources.[47] No one has convincingly shown how this capacity of the market mechanism can be reproduced by a central planning agency.[48] Theoretical proposals to overcome this fundamental defect of central planning invariably depend on introducing various kinds of market mechanism for their solution.[49] Thus, a social and political system that would respect the sovereignty of each human being cannot designate a selected group of individuals to delinate by rank the relative usefulness of things for others. Such an arrogation of authority to rank things is explicit in the proposal to limit the capital gains deduction to classes of assets deemed "productive" by the proponents of the legislation.

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[41] The mind-numbing complexity of Subchapter C of the Code is of intense concern to the Congress, and was very recently documented in the "Reform and Simplification of the Income Taxation of Corporations," a report by the staff Senate Finance Committee, Senate Print 98-95, September 22, 1983.

[42] Staff of the Joint Committee on Taxation, 97th Cong., 2d Sess., Description of Possible Options to Increase Revenues 167 (Comm. Print 1982); see also M. Brown, Tax Choices 50 (Roosevelt Center for American Policy Studies 1983).

[43] L. von Mises, Human Action 243-44 (3d Rev. Ed. 1966).

[44] *Id.*

[45] A.A. Alchian & W.R. Allen, University Economics 22-23 (3d Ed. 1972); L. von Mises, Human Action 203-05 (3d Rev. Ed. 1966).

Nor have historical attempts by political institutions to direct investments in a way beneficial to society as a whole been successful in practice. Indeed, governments are notoriously incapable of allocating resources as efficiently as the marketplace.[50] Even Communist countries are grudgingly allowing greater allocation of resources by market mechanisms because their command decisions have been disastrous failures.[51] In contrast the United States rose from the status of an economic pygmy to that of the leading economic power within 150 years substantially on the basis of respect for private property and free markets. Other Western nations have done the same. The proposal to allow capital gains treatment only to politically favored forms of investment contradicts the historical evidence regarding the elements that have made the American system economically strong.

If the issue is refocused from whether or not there are some types of assets that are "non-productive" to which types of assets have greater promise of being more productive, reasonable people can disagree on that question. But a paternalistic "father knows best" approach to tax policy for directing investment remains wholly inappropriate in a system where the citizen is sovereign and economic decisionmaking is not the province of a Central Planning Committee.[52] In our present investment marketplace, investors have the opportunity to become well informed and thus to understand the consequences of their own investment decisions. For example, given the mixed performance of common stock and bond investments during the past 15 years and more, we think it indefensible that Congress should say to individuals that they must bear a penalty of higher taxation if they choose one form of investment over others.

It should also be recognized that the proposal to restrict capital gains treatment to politically favored investments grants a special privilege to some persons and a special punishment to others. Any presumed benefit of the proposed limitation would not flow equitably to the citizens as a whole; rather, the people who own and operate the institutions that trade in the preferred investment media would reap legislated gains and those discriminated against would experience legislated losses. It is especially ironic that this proposal should be advanced at a time when the Government is striving to deregulate the financial industry, when banks are going into the securities business and securities dealers into the banking business. Deregulation is being promoted in order to enable all such institutions to compete more effectively for investors' funds, where their success or failure will be determined by market forces. The proposal to limit capital gains treatment would be significantly out of step with the entire thrust of recent Government actions to remove legislative obstacles to savers' investment alternatives.

VIII. THE PROPOSAL CANNOT BE JUSTIFIED AS AN ANTIDOTE TO SPECULATION

If underlying this proposal is a belief that individuals who realize gains on the sale of tangible assets are "speculators" whose investment rewards are earned at the expense of and upon the misery of others, the proponents ought to identify the members of this "speculator" class and show how they differ significantly from "speculators" in other assets.

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[46] Alchian, *supra*, at 56-57.

[47] *Id.* at 79-91.

[48] See L. von Mises, Human Action 698-715 (3d Rev. Ed. 1966); F. von Hayek, Individualism and Economic Order 119-208 (1948).

[49] E.g., J.A. Schumpeter, Capitalism, Socialism and Democracy 172-86 (3d Ed. 1950).

[50] See A. Nove, The Soviet Economic System 39-59 (1977); G.R. Feiwel, The Soviet Quest for Economic Efficiency 113-31, 485-540 (1972); M. Goldman, The Soviet Economy, Myth and Reality 86-108 (1968).

[51] A. Nove, *supra*, at 288-322; M. Goldman, *supra*, at 111-135.

[52] L. von Mises, Human Action 737-57 (3d Rev. Ed. 1966).

A much-cited student of our income tax system has observed that "investmnet and so-called speculation cannot be clearly separated" and that "[v]irtually all investors are speculators in the sense that they risk their wealth in accordance with their expectations of future prices and yields.[53] Another noted economist has pointed out:[54] "[I]n any real and living economy every actor is always an entrepreneur and speculator. . . . A capitalist is always also virtually an entrepreneur and speculator. He always runs the chance of losing his funds. There is no such thing as a perfectly safe investment."

Gold, silver, coins stamps, jewelry, antiques, art, and other tangible asserts are bought, owned, and sold by all classes of people for all types of reasons, virtually all of which are worthy of respect. Some buyers, to be sure, are "rich" by a presumed common standard, but so are some buyers of stocks and bonds. Most owners of tangible personal assets are not "rich." In the United States such investors and owners represent a cross-section of economic groups, as do owners of stocks and bonds.

Investments in tangible personal assets are made for the same motives as are investments in securities, bank deposits, or real estate, and they are made by the same cross-section of people. There is no class of "speculators" preying on the public; there are only investors whose motives are the same as all other investors. As a group, they differ only in their assessment of particular investment alternatives.

Any suggestion that investors in tangible assets can be singled out as "speculators" is also flatly contradicted by almost fifty years of legislative history. Although Congress has traditionally regarded the profits of the 'speculator' as unworthy of preferential treatment, it could see "no way to distinguish the 'speculator' from the 'investor' by reference to the nature of the assets held, for both simply held securities and sold for their own account.[55] Rather, Congress "resorted to . . . a 'holding period' requirement under which a capital asset has to be held a certain length of time to obtain preferential treatment.[56] As the relevant congressional committee put it in 1938, the division of capital gains into short-term and long-term was "for the purpose of separating, in a practical way, speculative transactions from investment transactions.[57]

When Congress recently increased the holding period from six months to one year, it noted that "there is no clear cut analytical distinction between investment and speculative gains," but attributed the holding period requirement in part to the notion that holding an asset for only a short time to obtain quick gains from short-term market fluctuations was a "distinctively speculative activity" that did not deserve special tax treatment.[58] Thus, Congress has always understood that the only practical way to identify "speculative" behavior was to view it as a temporal phenomenon. Insofar as investors in tangible assets are "speculating" in this sense, the holding period requirement will deny them preferential treatment just as it denies preferential tax treatment to investors in all other capital assets. No change in the present law is necessary to achieve this.

IX. GOLD EXEMPLIFIES THE USEFUL QUALITIES OF TANGIBLE ASSETS GENERALLY

We have noted that the special characteristics of many items of tangible property cause them to be desirable vehicles for the retention of real value as distinguished from investments denominated in a specific monetary unit. This is true of such disparate items as, for example, silver bullion or a painting by a recognized artist of the 18th century. But no durable good so fully exemplifies this useful characteristic as does gold in its various forms. It is appropriate to take special note of gold in this context since gold is invariably prominent among the classes of assets subject to attack as "non-productive," and in some formulations of the proposal it is separately and specifically itemized. In the view of some of the proponents of the limitation on capital gains, a special opprobrium seems to attach to gold.

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[53] R. Goode, The Individual Income Tax 182 (Brookings Institution 1976).

[54] L. Von Misis, Human Action 253 (3d Rev. Ed. 1966).

[55] Surrey, "Definitional Problems in Capital Gains Taxation," 69 Harv. L. Rev. 985, 999 (1956).

[56] *Id.*

[57] H. Rep. 1860, 75th Cong. 3d Sess. reprinted in 1939-1 C.B. 728, 733. See also Report of a Subcommittee of the Committee on Ways and Means on A Proposed Revision of the Revenue Laws, 75th Cong. 3d Sess. 37 (Comm. Print 1938): "A classification based solely upon the period of holding is not an exact method for segregating speculative from investment transactions, but it appears to be the only practicable method and is believed to be a sufficiently fair criterion for practical purposes."

[58] Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976, 94th Cong., 2d Sess. 426 (Comm. Print 1976).

This aspect of the attack on tangible assets is especially misguided given gold's historic role as one of the world's most permanent and indestructible forms of capital. The reasons why gold has retained its attraction for private investors are simple to understand and practical, not esoteric or mystical. Those reasons have been well summarized as follows: [59]

Because gold is scarce and because its extraction from natural deposits requires much effort in relation to the amount of gold produced, gold has a high exchange value. Moreover, the large accumulations now used as the official monetary stocks of the world (over one billion ounces) are many times annual production (recently about 40 million ounces annually); consequently, even quite large variations in production cause relatively small changes in the accumulated monetary stocks of gold during short periods. This tends to stabilize a money-credit system based on gold. Gold cannot readily be counterfeited, and it is almost impervious to deterioration. Quite simply, there appears to be no substance better suited for use as a monetary unit.

The qualities described above inhere to one degree or another in all forms of tangible personal items that historically have held out a reasonable prospect of sale at a gain over time. But as Paul Samuelson has observed, there are "[h]onest citizens who are convinced that inflation is coming and that free gold will hold its real value better than any other investment—better than common stocks, bonds, savings accounts, real estate, diamonds, paintings, antiques, and hoarding of commodities." [60] An instructive difference in the case of gold is the extent to which governments themselves have recognized the store-of-value and medium-of-exchange qualities in gold and have officially grounded monetary systems on these qualities. At various times in commercial and banking history, especially in the late 19th century, currency issued by governments or central banks typically represented gold actually held in vaults, and such currency was freely convertible into gold at fixed rates.[61] Today governments and central banking systems have found it convenient to abandon that right of conversion, but they have not abandoned the accumulation of gold itself. Nor have individual tradesmen and investors abandoned the useful role that gold can perform as a medium of exchange and store-of-value.

Governments maintain great hordes of gold for very practical reasons, none more so than the U.S. Treasury. Treasury's cache of gold in part grew to vast proportions by reason of a persistent balance of international payments in favor of the United States over a lengthy period during which imbalances in international payments were settled in gold.[62] The experience of Treasury during the period from 1933 through 1970, when it tried to maintain the world price of gold in dollars at $35 per ounce, is instructive. Initially, that price exceeded the world market judgment of the value of gold in dollars, and foreign governments significantly availed themselves of the chance to sell gold to the United States at the pegged price. Thereafter, and expecially in the 1960's, the $35 figure was considered low and foreign governments used their dollars to buy gold from the United States.[63] This extensive activity by governments in the exchange of gold for dollars over almost a half-century is not easily dismissed as involving a "non-productive" asset, unless the management of national and international monetary systems itself is an activity one is willing to characterize as "non-productive."

The attempt of the United States in the period following World War II to stabilize international exchange rates through the convertibility of the dollar into U.S.-held gold at a fixed rate was abandoned in 1971 to end the accelerating drain on the U.S. gold supply that had developed under that program.[64] The United States was unwilling to allow its entire reserve of gold to be transferred to foreign countries through the process of convertibility.[65] And it remains the case that the relative stability of any official currency turns significantly on the amount of gold still held by the system that issued the currency. United States Treasury officials know that as well as anyone else.

If it makes practical sense for the U.S. Government to maintain a significant degree of ownership of gold, it is difficult to follow the argument that such ownership by private individuals is fairly characterized as "non-productive." [66] Changes in the mechanisms employed by governments to implement monetary policy and international trade do not alter the nature of gold or its essential character as a form of capital. Nor is it necessary or pertinent to consider the arguments for and against any form of official gold standard. We need only observe that experience has shown that investments in gold are one means by which individuals may reasonably attempt to preserve wealth for future availability. Efforts by private citizens to do so should not be denigrated or impugned by the Government, since the Government significantly seeks to preserve the people's "wealth" by the same means.

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[59] E. Welker ed., Why Gold? 11-12 (AIER 1981).

[60] P. Samuelson, Economics 673 (11th Ed. 1980).

[61] *Id.* at 607-613.

[62] *Id.*

[63] See Hearing Before House Subcommittee on Consumer Affairs on H.R. 6054 (a bill to provide for the minting of the American Eagle Gold Coin) pp. 64-65 (September 28, 1982).

[64] P. Samuelson, *supara*, at 613.

[65] See A. A. Alchian & W. R. Allen, University Economics 785 (3rd Ed. 1972).

X. THE ECONOMIC AND CULTURAL SIGNIFICANCE OF THE TANGIBLE ASSETS INDUSTRY

As previously noted, there should be no illusions as to the impact the proposed capital gain limitation will have on producers and retailers of the affected tangible assets. Many of them will be put out of business, while other will limp along at a fraction of their previous levels of activity. The annual sales revenues of sellers of gold and silver bullion, art, bullion coins, numismatic coins, stamps, jewelry and antiques in the United States plainly total many billions of dollars. These industries provide employment for tens of thousands of employees and entrepreneurs. To the extent that the products involved are brought exclusively for consumption, production and trade will of course continue after enactment of the proposed capital gains limitation. But the present volume of trade allows for economies of scale throughout the production and selling process, so that the elimination of the investment incentive will necessarily greatly increase the future cost of consumption of the attacked assets.[67] Another major effect will be the likely decline in the flow of art objects into the United States and a concomitant increase in the flow of such objects away from the United States. This too, contradicts what we believe is a central policy of the Congress which is to encorage the development of museums and art collections within the United States itself.

The desiccation of such culturally enriching markets as those for art, jewelry and antiques may or may not be the explicit goal of the proponents of this legislation, but that surely will be the effect of it. It is through such markets that aesthetic standards are set and tested, and the existence of those markets lends substantial support to the creation of new works of material and aesthetic value. It is difficult to understand why Congress would even consider rendering an economic death blow to such culturally useful forms of commerce, the benefits of which are enjoyed by the entire population. Museums are the ultimate repositories of most of the nation's collected masterpieces in tangible form, and the people of the nation attend museums by the hundreds of millions. However, those museums cannot survive as such repositories except where trade in the collected items is allowed to flourish and importation of items is not artifically impeded. If art, jewelry, and antique collection is discouraged by the Government, private collection will atrophy, and preservation of the beauty and spirit of the people as expressed in works of art will disappear. Such a development may satisfy the cultural values of those who view such activity as "non-productive," but one must be skeptical that this reflects a view shared by many Americans.

XI. REVENUE ESTIMATES CANNOT BE RELIED UPON TO MEASURE THE EFFECT OF THE PROPOSAL

The Democratic Study Group estimates that elimination of capital gains treatment for "non-productive" assets will yield increased tax revenues of about two billion dollars annually.[68] By interpolation one can assume that the annual estimate of

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[66] The statutory prohibition against private ownership of gold by United States citizens in the period 1933 through 1974 does not support any contention that gold is "non-productive." The prohibition was imposed—and existing holdings called in at a fixed price—to deny to individuals any profit from the Government's decision to increase the fixed price of gold from $21 to $35 per ounce, and thereby to "devalue" the dollar. See Samuelson, Economics 263 (11th ed. 1980). Restoration in 1974 of this elemental economic freedom was forced on the Government by economic events and increasing investor sophistication. See Pub. L. 93-110, § 3, 87 Stat. 352 (1973); Pub. L. 93-373, § 2, 88 Stat. 445 (1974); Executive Order No. 11825, 40 Fed. Reg. 1003 (January 6, 1975).

[67] As noted earlier, the proposed legislation might also undermine the availability of the charitable deduction for assets that have appreciated in value in the hands of the donor. If this occurs, donations of valuable artworks, jewelry and other "collectibles" to charitable institutions would undoubtly be drastically reduced.

[68] DGS Special Report No. 98-6, March 21, 1983 at p. 4.

$2 billion is premised on reported gains in such assets of about $6.66 billion. But no revenue estimate can realistically assume that transactions will continue to occur at the same level and be reported with the same frequency under a 50 percent tax rate regime as under a 20 percent tax rate regime. "Ignoring the effect of a tax change on individual behavior obviously distorts the estimated impact of the proposed tax change on tax revenue." [69] It has been well recognized since the beginning of the income tax that any tax in gain from sales of property will cause taxpayers significantly to avoid such sales, giving rise to the "lock-in effect." [70] This is likely to be especially true if a dramatic increase in the tax on the sale of tangible assets is enacted. In addition to avoiding the sale of previously acquired property, taxpayers can be expected to avoid investing in the disfavored property, and in some cases to endeavors to hide the transactions from the tax authorities to a much greater degree than is now the case.

There is no evidence that these responses can be predicted by those who attempt to estimate the effect on revenue of a change in the way in which capital gains will be taxed. Nor is there any way that a revenue estimate can predict the negative effect on the value ascribed to assets if their sale will result in gain taxed at ordinary income rates. In fact, it is common practice for the Joint Committee on Taxation and the Treasury Department to make such tax revenue estimates on the assumption that there will be no change in the reported level of income as a result of the proposed changes.[71] Evidently, therefore, the revenue estimates so far attached to the "productive" asset proposal represent pure conjecture, and were developed without an attempt realistically to assess the conduct of millions of taxpayers following enactment of the change.

There has been at least one suggestion that the proposal to deny capital gains treatment to so-called "non-productive assets" can be justified as a means of obtaining greater compliance with the tax laws. D. Franasiak, "The Next Tax Bill," in United States Chamber of Commerce "Economic Outlook" 11-12 (September 1982). "'Productive' investments in this sense means transactions which can be traced by the IRS while "non-productive" investments do not leave a paper trail." *Id.* at 12. It is not explained just how the proposal would improve taxpayers compliance, but presumably the thought is that the higher tax on such assets would either discourage taxpayers from investing in this area where there is no "paper trail" or compensate for the IRS' inability to collect tax from those who do not report gains by taxing more heavily the honest citizens who do. Quite apart from the obvious unfairness of such a device to honest taxpayers, the rationale again seems to presuppose taxpayer behavior for which there is no evidence. The Department of Treasury, for example, in commenting a year ago on a bill which would have provided for the minting a gold coins, suggested that the compliance problem here is more complicated. Hearing before the Subcommittee on Consumer Affairs and Coinage of the House Committee on Banking, Finance and Urban Affairs on H.R. 6054, 97th Cong., 2d Sess. 20-21 (Sept. 28, 1982). On the one hand, taxpayers may fail to report gains—and thus may deny revenue to the government. On the other, taxpayers may report losses on such assets when they occur and thus take capital loss deductions—again reducing tax revenue. *Id.* In view this potential for abuse, Treasury concluded that making the sales of such assets totally tax exempt might very well lead to a net increase in tax revenue. *Id.* By contrast, the proposal to increase the tax on such capital gains, rather than to reduce it, may very well exacerbate the compliance problem rather than alleviate it.

Of course the Congress often must address issues of tax policy without the availability of accurate means of assessing the precise revenue impact of a given change in the tax law. But the difficulties of estimating the revenue effect of this particular proposal are so severe, and render any estimate so conjectural, that such estimates in this case cannot fairly constitute a basis for Congressional action. Rather, the policy implicit in the statutory change must itself serve as the sole rationale for its adoption. The Congress must decide whether the public interest—unquantified—would be served by imposition of a new and draconian tax penalty on the ownership of and trading in tangible assets by investors and collectors. As the foregoing discussion indicates, we fail to perceive how such an enactment could be defended.

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[69] M. Feldstein, ed., Behavioral Simulation Methods in Tax Policy Analysis 1-2 (NBER 1983). See also M. David, Alternative Approaches to Capital Gains Taxation 106 (Brookings Institution 1968) (author's prediction of effects of change in capital gains taxation not taking account of potential taxpayer reaction must be viewed "as a crude approximation that undoubtedly exaggerates" the result predicted).

[70] H. Rep. No. 1388, 67th Cong., 4th Sess. (1923); See Bittker, Federal Taxation of Income, Estates & Gifts 3-61 to 62 (1981).

[71] M. Feldstein, *supra*, at pp. 1-2.

STATEMENT OF INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA, UAW

The UAW appreciates this opportunity to present its views on the taxation of capital gains. On behalf of our 1.2 million members, we strongly urge this Committee to reject a reduction in the holding period distinguishing between short-term and long-term capital gains, and to start phasing out the preferential tax treatment of capital gains instead.

Our Union has a long tradition of concern and involvement in tax issues. We have been especially troubled by the increasing share of the tax burden shouldered by UAW members and working people in general. Passage of the Reagan-sponsored Economic Recovery Act of 1981 (ERTA) accelerated this process drastically. Corporations are now footing half as much of the federal tax bill as they did 10 years ago; the distribution of the tax load among individuals has shifted sharply away from the wealthy. The unfairness in the tax system is steadily undermining public support for adequate funding of useful and necessary social services and programs at all levels of government.

Just two years after Congress enacted ERTA with its lavish array of tax breaks on the rich, there is a movement back for more. The lower top bracket rates provided in the 1981 Act cut effective tax rates on capital gains from 28 to 20 percent. Should the holding period be reduced, the same group of taxpayers who benefitted from that change—and from the rest of the changes geared towards the upper-income households—would get additional tax relief. Almost three-fourths of the tax reduction from going to a 6-month holding period for long-term gains accrues to taxpayers with incomes over $50,000, and as much as 43 percent to those with incomes over $100,000.

Preferential rates for capital gains are not necessary to encourage equity investment; a thriving economy is. The same applies to other costly investment incentives in our tax code. Capital spending plummeted in the last two years as a direct result of the recession, and in spite of the ACRS and the richer investment tax credit passed in 1981. Rapid economic growth brings about high rates of plant utilization and the search for more efficient ways of production. These in turn are far more effective inducements for investment than tax breaks. Therefore, tax incentives end up as windfalls for what people and corporations would have done anyway.

The investment argument breaks down completely when capital gains are realized from "investing" in gold, collectibles, and other nonproductive assets: there is absolutely no economic justification for preferential tax treatment in such cases. Furthermore, the tax preference allows sheltering of income through "charitable" deductions—as in the too common practice of buying art objects, subsequently donating them to a museum, and then taking large deductions from taxable income based on the inflated appraisals of the objects' value.

From a revenue standpoint, the argument that a more lenient taxation of capital gains will "pay for itself" has also been proven wrong,as has the rest of the "supply-side" rhetoric. After reviewing the evidence from the cut in capital gains tax rates enacted in 1978, CBO's Joseph Minarik recently concluded that "in revenue-constrained times, a misperception that tax cuts for these or any other particular goals are cost-free (or even revenue-raisers) can leave the economy worse off."[1]

Indeed, the changes in capital gains are proposed at a time of bulging deficits—not just currently, when the economy is pulling free from the grip of the worst recession in half a century, but for the future. Just three days ago, CEA Chairman Feldstein reiterated that deficits are unlikely to shrink much smaller than the $200 billion annual level even if economic growth continues, unless something is done to the structure of federal revenues and spending. We believe off-year deficits must be reduced, and commend Chairman Rostenkowski and others for their efforts in raising revenues through tax legislation this year. We urge this Committee to complement their favorable report on that bill with no action on the holding period. As a first step down the road of phasing out the $16 billion-a-year capital gains exclusion, we call for eliminating the capital gains treatment of gold, art objects, and other nonproductive assets. The trend toward abolishing capital taxes altogether must be halted and reversed.

Thank you.

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[1] *Tax Notes*, May 1983.

STATEMENT OF THE NATIONAL SMALL BUSINESS ASSOCIATION

Mr. Chairman and Members of the Committee, we of the National Small Business Association (NSB) appreciate the opportunity to express our veiws on pending capital gains legislation.

The NSB, which was founded in 1937, is a nationwide organization of over 50,000 small and independent firms in all industries. It is active in the public policy area, having testified before Congressional committees on 32 occasions in the 97th Congress. We believe that this is an important part of representing the interests of new, small and local family and independent businesses throughout the country.

Despite the fact that a shorter holding period might benefit our members as individual investors in the stock markets, NSB believes that sound tax policy in the capital gain area for business and the economy as a whole would be to refrain from shortening the holding period, and to consider the advantages of increasing the capital gain exclusion to 80 percent after a five year period for certain types of productive investments.

LACK OF RATIONALE FOR SHORTENING THE HOLDING PERIOD

When Congress increased the holding period from 6 months to its present term of one year in the Tax Reform Act of 1976, the general explanation by the Joint Tax Committee focused on the following factors:

1. Congress wished to concentrate the special tax treatment for capital gains on assets held "for investment" rather than for speculative profit; and
2. The special capital gain rate is provided to recognize the fact that such gains are attributable to appreciation in value over a longer period of time and accordingly should not be taxed at individual progressive rates as though earned in the current year.

Historical precedent about the length of the holding period is ambiguous. Since 1913, the various judgments of Congress on this question have been as follows:

HISTORY OF CAPITAL HOLDING PERIOD

Years	Holding period
1922 to 1933	2 years.
1934 to 1937	4 differing periods ranging from 1 to 10 years.
1938 to 1941	2 differing periods of 18 months and 2 years.
1942 to 1976	6 months.
1977	9 months.
1978 to present	1 year.

From the figures, it appears that the weighted average of the holding period has been about 1 year, and a graduated rate was in effect for about 8 years.

Looking next at the judgment of the Securities and Exchange Commission, the expert executive agency in this field, their line has been drawn at 2 or 3 years.

This is embodied in Rule 144, which proscribes the period for which an original purchaser must hold his stock before disposing of it to an outside party, and that is 2 years, with restrictions, and 3 years without restrictions (17 CFR 230.144).

The venture capital community also has a view of this matter. Most new enterprises take five to ten years to mature to a point where they are cumulatively profitable and can sell their stock to the public, thereby enabling the venture capital entity to liquify its investment. For this reason, most venture capital partnerships are organized for a period of seven to ten years.

Common sense may also be applied to this question. It is difficult to make a case that an ordinary reasonable man would regard the dividing line between an investment and a speculation at 6 months.

SHORTER HOLDING PERIOD BLURS THE DISTINCTION BETWEEN ORDINARY INCOME AND CAPITAL GAINS

The business community knows that there is a distinction between ordinary income and the gains from appreciation of assets over a long period of time. Most small business owners plow every cent of profit back into their businesses so that they can modernize, remain competitive, and continue to earn a livelihood. Small business owners tend to acquire assets not for six months, one year, or two years, but for life.

Also, as we have seen, the venture capital community clearly recognizes the long lead time in nurturing fledgling new enterprises to health and profitability.

However, a shorter holding period would run the danger of blurring this distinction with the general public. In our view the next step might be to suggest that all capital gain income be taxed at ordinary income rates because no differences are perceived between capital gain and ordinary income streams. In fact, this theory of taxation has been persistently suggested by various tax theorists, such as Professor Alan Blinder of Princeton University.

We think it would be very unfortunate to lose this vital distinction in the tax law, and that shortening the holding period would materially jeopardize this position. A case in point is the impetus which raised the rates on capital gain income from 25 to 49.125 percent between 1969 and 1976. This had disastrous consequences for the new issues market, for venture capital, and for all small businesses in the country.

TWO-TIER CAPITAL GAIN STRUCTURE HIGHLY RECOMMENDED BY SEC FORUM

When the SEC government-business Small Business Forum on Capital Formation of September, 1982 came to consider the structure of capital gains taxation, two-tier capital gain was its fifth highest ranking recommendation. The specific suggestions were to maintain the present holding period for all investments and to increase the exemption to 80 percent after a five-year period, thereby lowering the capital gain rate to 10 percent for such long-term investments.

The Forum addressed itself to the legislation pending in the 97th Congress which proposed to reduce the holding period to six months or eliminate it completely. The final report of the Forum concluded:

"This system ultimately may serve to disadvantage small enterprises . . . If long term capital gains can be achieved with a six month investment in a relatively risk-free 'blue chip' stock, why would an investor purchase equity securities of a small enterprise when the risks are higher and the realization of benefits may take years?" (Final Report: SEC Government-Business Forum on Small Business Capital Formation, November 19, 1982, page 82).

The report listed the advantages of establishing such a two-tier five year step-down as follows:

"The system would introduce a better balance between risk and reward;

"The system would spur risk-taking and encourage longer term investments, which are the type needed for development and growth;

"The system would more adequately address the bunching problem since the individual's tax liability in the year of realization would be adjusted to recognize that the profit was earned over an extended period of years;

"Investment in new and small businesses would be promoted since realization of gains from such venture capital investments require an extended holding period;

"Since investors would have greater incentive to realize longer term capital gains than current income, businesses would be encouraged to plow back earnings to achieve greater growth rather than disbursing earnings to pay dividends;

"To the extent equity financing is more readily available, the debt/equity ratio on corporate balance sheets should improve, thereby reducing the risk associated with investment;

"Finally this system confers additional benefits for longer term investments, while preserving the current system for investments of a lesser duration."

We find these reasons persuasive, and believe that the Congress should find them likewise.

TWO-TIER SYSTEM CAN BE REFINED TO ACHIEVE HIGHER INVESTMENT PRODUCTIVITY

As Congress looks further at the possibilities of the two-tier capital gain, we believe that certain improvements can be made which will make it a more precise instrument for job creation, economic growth and technological progress.

A good starting point might be a bill which has already been introduced in the Senate, S. 1666. Some of the things that Congress might do to improve the efficiency of such a mechanism would include confining the step-down privilege to direct investments in productive corporations. This would put a premium on direct employment of capital in the process of production and distribution, rather than lodging it in antiques, collectibles, options, futures or other less immediately productive media.

Such a benefit would benefit both the venture capitalists who are at the leading edge of technology needed to preserve the country's competitive position, and also the long-term small business man who is trying to make a go of it in his local region, city, or community or neighborhood against increasing odds.

We at NSB would be glad to work with the Committee staff in developing such a proposal to the point where it may be seriously considered by the Committee and the Congress.

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